S. Hrg. 99-763

INTEGRATION OF U.S. POLICIES ON TRADE, EXCHANGE RATES, AND THE ACCUMULATED DEBTS OF LESS-DEVELOPED COUNTRIES

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

S. 1860 and S. 1866

MAY 13, 1986

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U.S. POLICIES ON TRADE, EXCHANGE RATES AND LDC DEBT

TUESDAY, MAY 13, 1986

U.S. SENATE, JOINT SUBCOMMITTEES ON INTERNATIONAL TRADE OF THE COMMITTEE ON FINANCE, AND SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,

Washington, DC.

The subcommittees met, pursuant to notice, at 10:05 a.m., in room SD-215, Dirksen Senate Office Building, Hon. John C. Danforth and John Heinz (cochairmen) presiding.

Present: Senators Danforth, Chafee, Heinz, Durenberger, Grassley, Long, Bentsen, Baucus, Bradley, and Mitchell.

Also present: Senators Dodd, Gorton, Mattingly, Hecht, Dixon, Sasser, and Cranston.

[The press release announcing the hearing, and the prepared written statements of Senator Heinz and Grassley and a staff report follow:]

[Press Release No. 86-040]

COMMITTEE ON FINANCE SETS HEARINGS ON TRADE ISSUES RAISED BY S. 1860

Senator Bob Packwood (R-Oregon), chairman of the Committee on Finance, announced today the scheduling of four hearings of the Subcommittee on International Trade on May 13, 14, and 15, 1986. Senator John C. Danforth (R-Missouri), chairman of the Finance Committee's Subcommittee on International Trade will preside at these hearings. All the hearings will be held in Room SD-215 of the Dirksen Senate Office Building.

Senator Packwood noted that a number of important issues are raised by S. 1860, sponsored by Senators Danforth, Moynihan, Dole, Bradley, and others. This series of hearings will afford an opportunity to examine the merits of S. 1860 and other bills which share its themes, Chairman Packwood stated.

On May 13, 1986, at 10 a.m. the Subcommittee will begin this series of hearings with Treasury Secretary James Baker. This hearing will concentrate on the integration of United States policies on trade, exchange rates and the accumulated debts of less developed countries. The Committee also invites public comment on S. 1866, principally sponsored by Senators Bradley, Mattingly and Moynihan.

STATEMENT OF SENATOR HEINZ

Mr. Chairman, I welcome Secretary Baker to this joint subcommittee hearing involving the two principal international trade and finance subcommittees of the Senate. I look forward to his report on important developments in two key areas that profoundly affect U.S. trade competitiveness in the world market; the Tokyo Summit agreement to correct dollar volatility and misalignment, and the plan which has come to be known as the Baker Initiative to address the continuing debt servicing problems of the major developing countries.

Progress in these two areas is vitally important because balanced U.S. trade has proved impossible in the face of severely misaligned exchange rates and the collapse of LDC exports markets which represented roughly 40 percent of U.S. exports only a few years ago.

In the Banking Committee, we have been devoting considerable attention to restoring export market access, the management of monetary policy and its effect on exchange rates, and the trade and financial consequences of international debt. We are undertaking a series of hearings on these issues to explore the measures the United States should be taking to resolve these problems, and we anticipate marking up legislation. From my perspective as Chairman of the Subcommittee on International Finance and Monetary Policy, I would like to share with you some of the thinking we have done on these questions.

It is important to recognize that until quite recently, the trade and international economic ramifications of U.S. domestic policies have received scant notice in the process of setting fiscal and monetary policies. U.S. competitiveness in world markets has eroded as key sectors of the U.S. economy suffered through a "trade depression", and unsustainable worldwide trade imbalances resulted. The drift has gone on for so long that many fear that trade balance can only come about through major dislocations in the trading systems and the U.S. economy.

Given these dangers, there has been a crying need for U.S. leadership. Finally we are beginning to see it in the Administration's various policy pronouncements and actions over the last year. Seven months ago in Seoul, the Secretary proposed a growth oriented approach to resolving the debt problems of the major LDC debtors. In late October at the Plaza Hotel, the G-5 governments altered longstanding policy against coordinated exchange market intervention with announcement of a new policy aimed at expediting necessary exchange realignments and smoothing market volatility. Finally, last week in Tokyo, the summit countries agreed to a program of intensified policy coordination based on objective economic indicators (GNP growth, inflation, unemployment, interest and exchange rates, etc.) to stabilize the monetary system. Assessing the adequacy of those actions requires that we be fully aware of the magnitude of the problem we face.

Looking first at exchange rates, the high value of the dollar in recent years has contributed to the drifting away of U.S. industrial strength, forcing efficient U.S. producers to move overseas or give up exporting. American manufacturers have suffered the loss of domestic and foreign market shares which, if not permanent, will at least require more than marginal shifts in exchange rates and major sales efforts to reverse.

We must also recognize the limits of our theories. The floating rate system did not respond to large U.S. trade deficits with a decline in dollar value and reduction of those deficits. Despite a dramatic decline in the value of the dollar over the last year, trade deficits continue to grow to record levels. In fact, with capital flows exceeding trade flows by a factor of 10 to 1 in the world economy, it is clear that classical theory's emphasis on merchandise trade is outdated.

Without question, careful management will be needed and the success of the Tokyo action plan will depend on our resolve to set the market signals correctly, to monitor performance closely, and to intervene in exchange markets and alter policies as needed.

Turning to the continuing debt problems of major developing countries, it is clear that this is the second key factor reducing the ability of U.S. firms to sell overseas. Until we see significant improvement in the major debtor economies, our own economic vitality will be constrained, and their economic vitality and political stability will be severely hampered. For these reasons, the announcement of the Baker Initiative last fall was another welcome development.

That plan took a very sensible approach to the debt problem. It recognized that the economic future of the debtors rests largely in their own hands through the establishment of domestic policies that promote growth. However, recovery also depends on many factors outside the debtors' control: efforts of developed countries to provide a stable international economic environment with low inflation and interest rates; access to markets and foreign credit, as appropriate; and a supportive posture by international institutions, national bank regulatory agencies, and the like. In sum, the plan requires cooperation by all parties to the debt problem: debtors, lenders and international agencies.

So far the record on the Baker Initiative is sketchy. Some of the debt burdened countries are reluctant to work with the IMF and play by the rules of the game. Mexico, Venezuela, Nigeria and others have been hard hit by oil price declines. It is not clear that they are taking the steps necessary to cope with these new developments and some would argue they are now insolvent.

We look forward to the Secretary's report on the debt problem, and hope for evidence that the debtors are indeed making necessary policy reforms, that banks are living up to their funding commitments, and that the World Bank and IMF are developing effective programs to support the debtors.

Most important, we seek confirmation that the recent Administration initiatives on monetary reform and LDC debt represent a turning point for U.S. international economic policy—that the Administration has learned its lesson from the economic damage caused during the last five years of international turmoil.

Congressional sentiment is clear, as indicated by the Trade Enhancement Act: international economic policy must be a major part of the national policy debate in the United States. The Administration must have active—not passive—policies on misaligned exchange rates, coordinated economic performance among Summit nations, and LDC debt management. The Congress must be able to assure the American people that the government is doing its utmost to promote a stable and predictable international economic environment in which our businessmen can compete successfully. I look forward to the Secretary's report.

SENATOR CHARLES E. GRASSLEY

Mr. Chairman, I am extremely pleased that this committee has begun the process of looking at some of the critical issues that have a major bearing on our trade deficit.

Our economy is not like the family dog . . . it won't go or stay on command. Our hopes and doubts about the effectiveness of our budget balancing plan to relieve the U.S. economy from the twin pressures of the fiscal and trade deficits are balanced on a knife's edge.

The external debt of developing nations will reach one trillion dollars by the end of 1986, according to the World Bank. Many financial experts feel that before the end of 1987, the debt problem will demand joint government intervention by the United States, Japan and the European Community on a considerably larger scale than currently envisioned by these countries.

Currently lower interest rates, falling oil prices, the weaker dollar, price stablity and the prospect of a lower federal deficit have all combined to brighten the U.S. economic landscape. Yet, fifty economists polled through blue chip economic worldscan predict an average of a 3 percent real growth for the U.S. economy in 1986. In addition, the panel saw the first quarter of 1988 as the beginning of a new U.S. economic recession.

Analysts are also warning that aggressive marketing by foreign sellers in the United States, brand loyalties to many foreign goods, and the willingness of foreign sellers to forego some profits in order to hang on to their U.S. market shares will counteract somewhat the decline of the dollar in the process of balancing U.S. trade.

For these, as well as a host of other reasons, reform of the International Monetary System must move to center stage on any economic debate. There must be a basic foundation of improved international cooperation and policy commitments by all countries for any strengthening of the international system to work. It is for these reasons that I was pleased to see President Reagan sit down with six other heads of state at the Tokyo Summit to discuss a world economy marked by volatility. For volatility feeds volatility as banks and business focus their attention on exchange gains and losses rather than on trade and wealth creation.

Mr. Chairman, I look forward to the presentation of Secretary Baker's testimony on the Tokyo Summit, the LDC debt problem, and on legislation S. 1866 presently before this committee.

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United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510

MAY 12, 1986

MEMO

FROM: FINANCE COMMITTEE TRADE STAFF (LEN SANTOS 4-5472)

TO: FINANCE COMMITTEE MEMBERS

SUBJECT: MAY 13, 1986 HEARING ON UNITED STATES POLICIES ON TRADE, EXCHANGE RATES AND LDC DEBT

The Subcommittee on International Trade will conduct a hearing at 10:00 a.m., May 13, 1986, on the integration of United States policies on trade, exchange rates and the debts of the less developed countries. The hearing will be held in SD-215 of the Dirksen Senate Office Building.

I. The Context

It is now widely accepted that the accumulation of large U.S. trade deficits during 1981-1986 is, in large part, a reflection of two realities: the relative strength of the U.S. dollar and the difficulty experienced by less developed countries in servicing their external debts. In spite of the role of the dollar's exchange rate and LDC debt in generating unprecedented U.S. trade deficits, U.S. policy with respect to both of these factors was non-interventionist during 1981-1985. In 1985, however, the United States began to develop new approaches to both of these factors. The extent to which these new approaches are motivated by trade policy considerations, and the consequences of these new approaches, are unclear at this writing.

II. Dollar Exchange Rate

The attached memorandum, prepared for Finance Committee hearings held April 23-24, 1985 describes the history of the exchange rate system, its evolution into a floating rate system and its impact on the trading system. Since those hearings, United States policy on exchange rates has changed. Following a September 22, 1985 meeting between U.S. Treasury Secretary Baker and his counterparts from Japan, West Germany, the United Kingdom and France (the G-5), it was announced that the G-5 had agreed to cooperate in a devaluation of the dollar. This represented a shift from the previous U.S. position of intervening in exchange markets only to correct "disorderly" market conditions. The September 22 announcement has been followed by a marked depreciation in the exchange value of the dollar, although, as Chart 1 indicates, the September 22 announcement was not the turning point for the dollar, which had been weakening since February 1985.

At the May 4-6, 1986 summit meeting in Tokyo of the heads of state of the largest industrialized democracies, agreement was reached to take "remedial measures where there are significant (exchange rate) deviations from an intended course." While this new approach is described as a "managed float", it may be more accurate to describe the new element as the willingness of the United States to participate in the "managed float" and of other countries to actively coordinate their policies on exchange rates.

Although the dollar has depreciated by more than 35 percent against the Japanese yen and somewhat lesser percentage against other major currencies, it has not depreciated against all currencies. Canada, Korea and Taiwan are some of the major U.S. trading partners whose currencies have not strengthened against the U.S. dollar. This uneven depreciation of the dollar is one reason the U.S. trade deficit has continued to grow. Most experts also believe in the "j" curve theory, in which established trade flows suffer an unfavorable valuation effect in the short term.

III. Less Developed Country Debt

Although there are many less developed countries (LDCs) which have accumulated large external debts, liquidity problems are most acute among the Latin American debtors since four-fifths of their borrowing was obtained from commercial sources at market rates. Much of the borrowing by other LDCs was obtained from official sources at concessional rates. Accordingly, the liquidity problems which have forced LDC debtors to restrict their imports have been concentrated in the Latin American debtors. Export growth in the 1960-1980 period exceeded real interest paid on external debt. Thus, the debt-to-export ratio in the Latin American debtors would have declined had these countries not been borrowing all the interest owed and more. But since 1980, high interest rates and slow growth in the world economy have turned the outlook around. Large non-interest surpluses are now necessary merely to stabilize the debt-to-export ratio.

The initial response to this debt crisis was that the governments of the industrialized countries and the IMF collaborated in 1982-85 to keep the debt from being repudiated and to maintain the appearance of its continued service. The collaboration took the form of prescribing adjustment programs for the debtor countries, case by case, which would bring about rapid and large improvements in their current accounts. As a counterpart, the commercial bank-IMF cartel would provide limited amounts of new money to cover that part of debt service which could not immediately be met by an adjustment of trade balances toward surpluses.

As Chart 2 and Tables 1 and 2 indicate, the consequences of this approach for the U.S. trade balance have been extremely negative. As these debtor countries have been forced to accumulate trade surpluses to pay interest on their external debt, they have imported less and exported more. From 1981 to 1983, U.S. exports to Latin America declined by $16 billion while U.S. imports from Latin America grew by about $3 billion.

In spite of these efforts, debt and interest payments as a fraction of national income have increased so much that even very large trade surpluses have not been enough to keep the debt from growing. In 1977, interest payments amounted to only 2 percent of income; by 1980 they had risen 3.8 percent of income; and by 1985 to 5.3 percent. The real interest burden has grown even more dramatically. Over the period 1977-1985, Latin American external debt increased from 30 percent of national income to 46 percent.

Chart 3 shows Latin America's trade balance and (nominal) interest payments. The chart highlights the major shift in the external balance between the pre- and post-1982 periods. As a result, there has been a net flow of real resouces from Latin America to the rest of the world, principally to the developed countries. Thus, these surpluses have been achieved by cutting real wages and standards of living and by suspending investment and imports. Table 3 reflects the fact that in 1985, Latin American per capita income was more than 7 percent below the 1980 level, with the decline reaching 20 percent in some countries. These severe domestic consequences of the need to generate large trade surpluses have raised questions about the sustainability of these conditions and their implication for social and political stability in the region.

During 1981-1985, the United States had treated this debt problem as private matters between the creditor banks and the Latin American debtors. But in October 1985, Treasury Secretary Baker announccd a new plan for dealing with this debt situation.

The plan had three elements. First, the debtor countries would pledge themselves to economic reform by giving market forces a greater role in the economy. Second, the commerical banks would agree to increase lending to the affected countries by 3 percent per annum, less than the interest rate, but more than they had been doing in 1985. Third, the IMF, World Bank and multilateral development banks (e.g., the Inter-American Development Bank) would increase their lending to the debtor countries. The World Bank in a departure from its tradional role in developing country investment projects, is to direct the flow of resources. All told, this plan envisions a three year lending increase of $29 billion, of which $20 billion would come from commercial banks and $9 billion from the World Bank.

The continuation of this debt crisis raises questions about the exposure of U.S. banks. Their claims are highly concentrated. The largest nine American banks accounted for more than 60 percent of the LDC loans and the next fifteen banks for another 20 percent. For the major American banks, loans to the five largest Latin borrowers amount to over 100 percent of stockholder's equity.

The decline in oil prices and interest rates have increased the chances that some LDC debtors may be able to grow out of their debt. But for an oil exporting country like Mexico, the decline in oil prices will compound the already severe strains imposed by Mexico's large external debt.

IV. Summary of S. 1866

TITLE I. MEASURES RELATING TO EXCHANGE RATES

Section 101 and 102. Findings and Policy.

Since the GATT is premised on the Bretton Woods International Monetary System which has been abandoned, and the dollar's role as a reserve currency makes it particularly vulnerable to capital movements, the United States should seek to achieve an exchange rate for the dollar which avoids prolonged imbalances in the current account.

The G-5 countries should coordinate monetary and fiscal policies with the objectives of eliminating imbalances in trade and capital flows and stablizing exchange rate through the coordinated participation by central banks in international currency markets.

Section 103. Negotiating Authority

Section 103 requires the President, within six months of enactment, to enter into negotiation with other G-5 countries to improve the functioning of the international monetary system and to enhance the role of the G-5 to coordinate fiscal and monetary policy, to achieve convergence of G-5 policies on money growth, inflation, fiscal policy, interest rates and other factors; to enter into negotiations with other countries to achieve reciprocal opportunities for investment, "thereby eliminating a major factor contributing to exchange rate misalignment and improving the economic efficiency of international investment flows."

Section 103(b) requires the Secretary of the Treasury and the Federal Reserve Board to accumulate foreign currencies in sufficient quantities to make participation in foreign exchange markets effective and credible.

TITLE II. MEASURES RELATING TO DEVELOPING COUNTRY DEBTORS

Section 201. Findings

A comprehensive, multilateral or bilateral government approach is required to the problem of developing country debt, which stifles U.S.

exports, disrupts patterns of international capital flows, and prevents economic growth for developing countries. The United States should negotiate the removal of a variety of barriers to imports and foreign investments which inhibit the development of developing countries.

Section 202. Negotiating Objective

Generally, to open developing country markets while renegotiating their debt service, thus benefiting both developing countries and the United States.

Section 203. Authority and Directives

Section 203 authorizes the Export/Import Bank to establish a $10 billion trade expansion loan guaranty and insurance program. The purpose of the program is to support U.S. exports to specific developing countries; however, the program is available for exports to a particular country only if private sector access to its facilities in the developing countries at least equal to that of the public sector and the developing country is removing existing trade and investment barriers. The program would replace the Compensatory Financing Facility, which would be terminated and its assets transferred to the program.

In addition, the President is authorized to negotiate with the OECD countries to eliminate official financing of or support for new mining or production facilities in developing countries where the commodity in question is in oversupply in international trade. The President is also authorized to negotiate with members of multilateral development banks an agreement prohibiting the furnishing of assistance by those banks for new mining or production facilities for commodities that are in oversupply.

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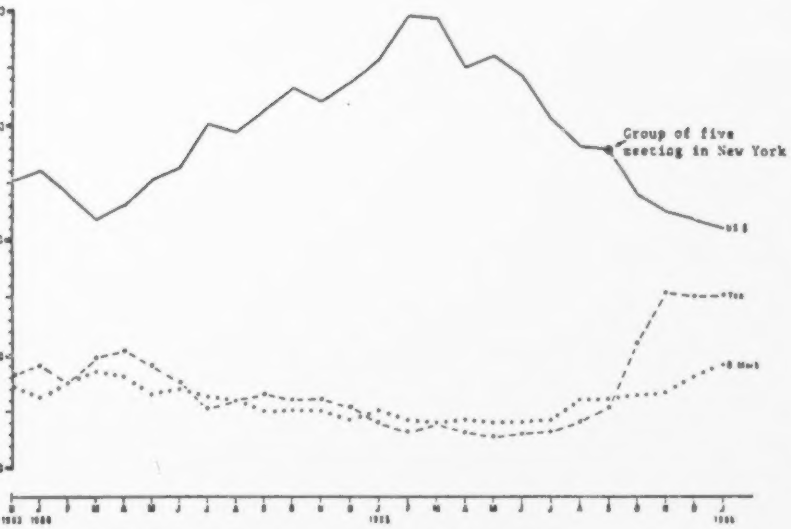
CHART 1

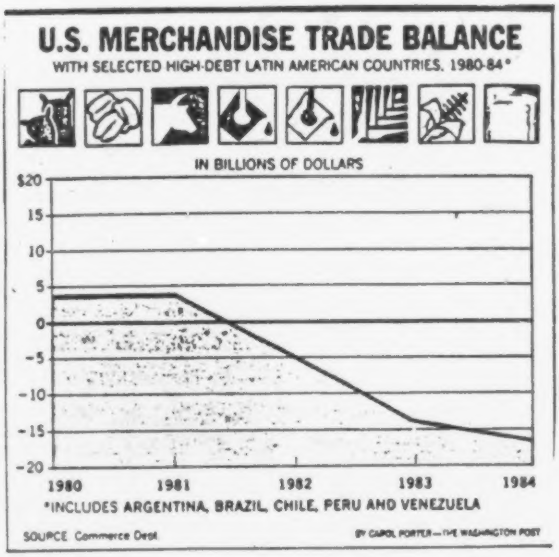
REAL EFFECTIVE EXCHANGE RATE MOVEMENT 1984-1985

(1980-82 average = 100)



Source: Morgan Guarantee Trust Company: World Financial Markets.

CHART 2



U.S. MERCHANDISE TRADE BALANCE

WITH SELECTED HIGH-DEBT LATIN AMERICAN COUNTRIES, 1980-84*

*INCLUDES ARGENTINA, BRAZIL, CHILE, PERU AND VENEZUELA

SOURCE: Commerce Dept.

BY CAROL PORTER—THE WASHINGTON POST

CHART 3

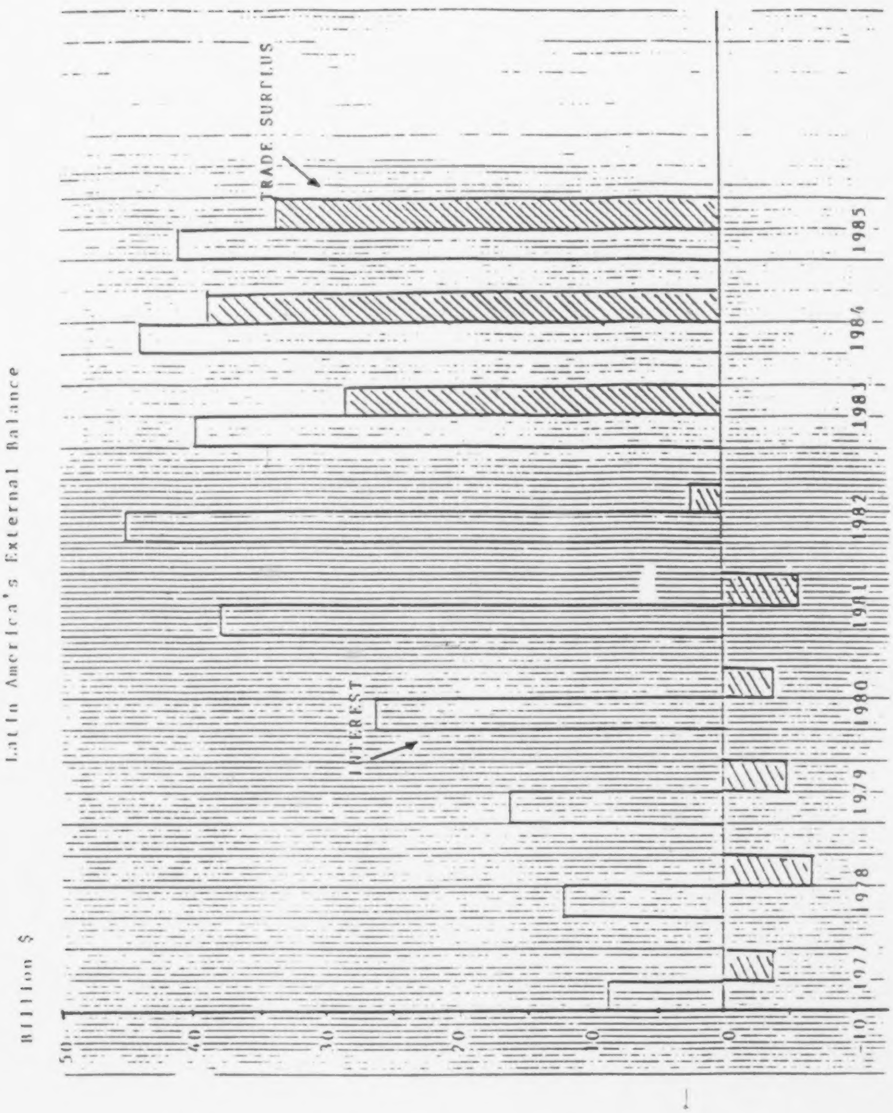

Latin America's External Balance
Billion $
TRADE SURPLUS
INTEREST
1977
1978
1979
1980
1981
1982
1983
1984
1985
50
40
30
20
10
0
-10

TABLE 1

U.S. Exports To Latin America
(U.S. $ Billions)

	1981	1982	% Chg.	1983	% Chg.	1984	% Chg.	1985	% Chg.
ARGENTINA	2.2	1.3	-41	1.0	- 23	0.9	- 10	0.7	- 22
BOLIVIA	0.2	0.1	-50	0.1	---	0.1	---	0.1	---
BRAZIL	3.8	3.4	-11	2.5	- 26	2.6	+ 4	3.1	+ 19
CHILE	1.5	1.0	-33	0.7	- 30	0.8	+ 14	0.7	- 12
COLOMBIA	1.8	1.9	+ 6	1.5	- 21	1.4	- 7	1.5	+ 7
ECUADOR	0.8	0.8	---	0.6	- 25	0.7	+ 17	0.6	- 14
PARAGUAY	0.1	0.08	- 20	0.04	- 50	0.06	+ 50	0.1	+ 67
PERU	1.5	1.1	- 27	0.9	- 18	0.7	- 22	0.5	- 29
URUGUAY	0.2	0.2	---	0.1	- 50	0.1	---	0.1	---
VENEZUELA	5.4	5.2	- 4	2.7	- 48	3.4	+ 26	3.2	- 6
SOUTH AMERICA	17.5	15.0	- 14	10.2	- 32	10.8	+ 6.0	10.5	- 3
MEXICO	17.8	11.7	- 34	9.1	- 22	12.0	+ 33	13.6	+ 13
CARIBBEAN BASIN	6.6	6.3	- 5	5.8	- 8	6.2	+ 7	5.9	- 5
TOTAL LATIN AMERICA	41.8	33.0	- 21	25.0	- 24	29.0	+ 16	30.1	+ 4
U.S. EXPORTS TO REST OF WORLD	191.8	179.0	- 7	175.0	- 2	188.5	+ 8	183.0	- 3
U.S. EXPORTS TO WORLD	233.7	212.2	- 9	200.3	- 6	217.8	+ 9	213.1	- 2

NOTES: 1/ Exports are U.S. Total Exports (F.A.S. Value).
2/ Total figures may differ from sums of the columns due to rounding.
3/ Caribbean Basin includes Central America, Islands, Guyana, and Suriname.

SOURCE: USDOC FT-990 (SITC/SCHEDULE E)

TABLE 2

U.S. Imports From Latin America
(U.S. $ Billions)

	1981	1982	% Chg.	1983	% Chg.	1984	% Chg.	1985	% Chg.
ARGENTINA	1.2	1.2	---	0.9	- 25	1.0	+ 11	1.2	+ 20
BOLIVIA	0.2	0.1	- 50	0.2	+100	0.2	---	0.1	- 50
BRAZIL	4.8	4.6	- 4	5.4	+ 17	8.3	+ 54	8.1	- 2
CHILE	0.7	0.7	---	1.0	+ 43	0.9	- 10	0.9	---
COLOMBIA	0.9	0.9	---	1.0	+ 11	1.3	+ 30	1.5	+ 15
ECUADOR	1.1	1.2	+ 9	1.5	+ 25	1.8	+ 20	2.0	+ 11
PARAGUAY	0.05	0.04	- 20	0.03	- 25	0.04	+ 33	0.03	- 25
PERU	1.3	1.1	- 15	1.2	+ 9	1.4	+ 17	1.2	- 14
URUGUAY	0.2	0.3	+ 50	0.4	+ 33	0.6	+ 50	0.6	---
VENEZUELA	5.8	5.0	- 14	5.2	+ 4	6.8	+ 31	6.8	---
SOUTH AMERICA	16.3	15.2	- 7	17.0	+ 12	22.3	+ 31	22.3	---
MEXICO	14.0	15.8	+ 13	17.0	+ 8	18.2	+ 7	19.4	+ 7
CARIBBEAN BASIN	10.5	8.5	- 19	9.6	+ 13	9.5	- 1	7.4	- 22
TOTAL LATIN AMERICA	40.7	39.5	- 3	43.5	+ 10	50.0	+ 15	49.0	- 2
U.S. IMPORTS FROM REST OF WORLD	232.7	215.4	- 7	226.4	+ 5	291.2	+ 29	312.6	+ 7
U.S. IMPORTS FROM WORLD	261.0	243.2	- 7	269.9	+ 11	341.2	+ 26	361.6	+ 6

NOTES: 1/ Imports are U.S. General Imports (C.I.F.).
2/ Total figures may differ from sums of the columns due to rounding.
3/ Caribbean Basin includes Central America, Islands, Guyana and Suriname.

SOURCE: USDOC FT-990 (SITC/SCHEDULE A)

TABLE 3

TABLE 3 Growth and Investment, Large Latin American Countries, 1980-1985.

Country.	Change in Per Capita GDP, (%). 1980-85	1984-85.	Investment/GDP (%) 1980	1984*
Brazil	-3.0	4.8	22.5	15.7
Mexico	-2.7	1.3	24.8	16.3
Argentina	-17.7	-4.5	22.4	16.6
Venezuela	-20.8	-2.7	25.2	14.3
Chile	-9.1	0.2	16.6	12.0

Source: CEPAL, IFS. *Data in this column for Argentina and Chile are for 1983.

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United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510

APRIL 22, 1985

MEMO

FROM: FINANCE COMMITTEE STAFF (LEN SANTOS x4-6953)

TO: FINANCE COMMITTEE MEMBERS

SUBJECT: THE ROLE OF FLOATING EXCHANGE RATES IN THE INTERNATIONAL TRADING SYSTEM

The Finance Committee will conduct hearings on April 23 and April 24, 1985 on the viability of the international trading system in an era of floating exchange rates. The hearings are scheduled from 9:30 a.m. to noon on April 23 and 24, as well as from 2:30 p.m. to 4:30 p.m. on April 23. The hearings will be held in SD-215. A list of the witnesses is attached hereto.

I. ROLE OF EXCHANGE RATES

An exchange rate is the price of one currency in terms of another currency. The foreign exchange market, where one currency is exchanged for another, is a network of commercial banks, brokers, central banks, and customers who communicate easily with each other. When one dollar buys fewer units of a foreign currency, the dollar has depreciated; and conversely, when one dollar buys more units of a foreign currency, the dollar has appreciated. When a country's currency appreciates, its exports increase in price in terms of other currencies and imports diminish in price in terms of its own currency.

II. THE BRETTON WOODS ERA

A. The Rationale

The negotiations that established the postwar international monetary system at Bretton Woods, New Hampshire, in July 1944, were heavily influenced by a desire not to repeat the major mistakes of the period between the wars. The British and American planners of the postwar monetary order saw fluctuating and misaligned exchange rates, completely free capital movements, and completely autonomous national monetary and fiscal policies as incompatible with an open trading system and the achievement of high levels of employment and growth. They wanted collective intergovernmental management of the quantum of international liquidity, of international capital flows, and of exchange rates and national adjustment policies. Sir Kingley Wood, British Chancellor of the Exchequer, summarized this view in 1943:

> "We want an orderly and agreed method of determining the value of national currency units, to eliminate unilateral action and the danger which it involves that each nation will seek to restore its competitive position by exchange depreciation. Above all, we want to free the international monetary system from those arbitrary, unpredictable and undesirable influences which have operated in the past as a result of large-scale speculative movements of capital. We want to secure an economic policy agreed between the nations and an international monetary system which will be the instrument of that policy. This means that if any one Government were tempted to move too far either in an inflationary or deflationary direction, it would be subject to the check of consultations with the other Governments, and it would be part of the agreed policy to take measures for correcting tendencies to dis-equilibrium in the balance of payments of each separate country."

1. Liquidity

This collective intergovernmental management of money proved impossible, and the world turned to the dollar standard, in which international reserves were determined mainly by the balance of payments deficits of the United States.

2. Capital Movements

Collective international monetary management proved no more feasible for capital movements than it did for liquidity creation. The IMF articles approved at Bretton Woods provided for freedom from exchange controls only on current transactions; significantly, the postwar planners envisaged that countries would need the latitude (and, in extreme cases, should be required) to control disequilibriating movements of short-term capital. The Anglo-American planners of Bretton Woods believed that governments would have to protect the system against the uncontrolled activities of private banks. Secretary of the Treasury Henry Morgenthau went so far as to describe the purpose of the Bretton Woods Conference as "to drive the usurious money lenders from the temple of international finance." The widely-held view at Bretton Woods was that the great volality of exchange rates and massive flows of speculative and flight capital during the period between the wars were prima facie evidence of the distablizing and disequilibriating nature of capital flows and the undesirability of floating exchange rates.

3. Adjustment

Finally, international monetary management also proved inoperable for the international adjustment process. The postwar monetary order was to be based on fixed exchange rates, which could be adjusted to correct a "fundamental disequilibrium" through a process of international consultation and agreement. But it proved impossible to agree on the appropriate balance between deficit and surplus country responsibilities. At the end of the Bretton Woods conference, national autonomy was being emphasized instead of supranationality.

B. The System in Operation

Under the Bretton Woods system, the value of the dollar was defined in terms of gold (and convertible into gold) and all the other currencies were fixed in relation to the dollar. The exchange rate for each currency could fluctuate only one percent above or below the par value of the currency--if it fluctuated more, each country was expected to buy or sell its own currency to prevent wider fluctuations. Consequently, the monetary authority of each country was responsible for maintaining the exchange rate of its currency.

1. The Role of the IMF

The IMF was established primarily to promote international monetary cooperation and exchange rate stability and to help members meet temporary balance of payments deficits. Quotas were established for each member country, which determined its voting rights and contributions. Each member contributed 25 percent of its quota to the IMF in gold or U.S. dollars and 75 percent in its own currency. Member countries could then borrow from the IMF (with the IMF imposing conditions which were more restrictive the greater the percentage of a country's total quota that the member was borrowing) for balance of payments financing.

It was anticipated that the short-term balance of payments deficits and surpluses would be adjusted by using international reserves or by borrowing from the IMF, while long-term surpluses and deficits were to be adjusted by changing the par value of a country's currency (devaluation or revaluation) and by deflating the domestic economy (for example, if the economy is deflated, prices and income will decline, leading to an increase in exports and a decrease in imports, and an ultimate improvement in the balance of payments).

2. The System Under Stress

In the 1960s it became apparent that the Bretton Woods system had serious deficiences. First, U.S. dollars were the world's currency and increases in world liquidity depended on increases in U.S. balance of payments deficits. At the same time, other countries were less willing to hold dollars as the U.S. balance of payments deteriorated. Secondly, the large deficit countries could not devalue their currencies, because other countries would follow and the devaluation would be ineffective, while upward revaluation of currencies for surplus countries, which would have hurt their export industries, was not attempted. Third, deficit countries were unwilling (and sometimes legally unable) to deflate their economies because of domestic economic pressures and surplus countries, where the problems were not as imminent as for deficit countries, usually chose not to inflate.

The United States experienced larger and larger balance of payments deficits in the 1960s. The deficits provided a much needed increase in international reserves because the countries receiving these dollars as a result of balance of payments surpluses retained them as an international reserve asset. However, the deficits also contributed to periodic speculative capital flows out of the dollar as financial market participants expected a dollar devaluation.

3. Attempts to Restore Stability

Several attempts were made to stabilize world financial markets in the 1960s. One of these was the gold pool, which was created in November 1961 in response to a flight from dollars into gold. The Bank of England, with stocks of gold contributed by central banks of eight countries, bought and sold gold in order to stabilize the price of gold. After the 1967 sterling devaluation and the expectation by foreign exchange market participants that the United States would increase the price of gold (that is, devalue the dollar), the speculative flight from dollars and sterling into gold became too heavy for the gold pool. In March 1968, the governors of the central banks announced they would no longer buy and sell gold in the private market to stabilize the price. A two-tier gold market was thus established, in which central banks would buy and sell gold among themselves at $35 an ounce, while the price of gold in the marketplace would depend on demand and supply.

4. The Nixon Shock

Speculative capital flows continued in 1969 and again in 1971. At a Camp David meeting with President Nixon in August 1971, Secretary of the Treasury Connally described how the economy was expanding too slowly, inflation was not subsiding, the trade balance was negative, and the overall balance of payments was in mammoth deficit. On August 15, 1971, President Nixon announced a tax credit for investment in U.S.-made equipment, repeal of the federal excise tax on automobiles, a speedup in scheduled personal income tax exemptions, a large cut in federal spending and foreign aid, and a 90-day wage and price freeze. Most importantly, the President announced that the U.S. government would eliminate the convertibility of the U.S. dollar into gold (thus severing the ties of gold to the international monetary system) and announced that the dollar would float against other currencies. Finally, a ten percent inport surcharge was imposed.

5. The End of Bretton Woods

In the Smithsonian Agreement of December 1971, the U.S. dollar was devalued and fixed exchange rates were reestablished, but convertibility between the dollar and gold was not reestablished. After considerable speculative activity, the U.S. devalued again in February 1973 and after further speculative pressure, in March 1973, fixed exchange rates were abandoned. This represents the end of the Bretton Woods system. Since then, exchange rates have been free to fluctuate, although governments have intervened in foreign exchange markets, heavily at times, to reduce some of the fluctuations. Consequently, the current system is referred to as a "managed float."

III. THE FLOATING EXCHANGE RATE ERA

A. 1972-1976

Adoption of floating exchange rates was a crisis response to unsustainable disequilibrium in the foreign exchange markets rather than a planned international monetary reform. After the second initiation of exchange rate flexibility in 1973, the announced objective of official reform negotiations was to secure prompt return to a system of "stable but adjustable" par values. The negotiations on international monetary reform by the Committee of Twenty (C-20) during the period 1972-74 gradually accepted the feasibility of floating exchange rates. Negotiators slowly recognized that a return to the par value system was neither feasible nor urgently needed. But agreement on floating exchange rates as the basis for the international monetary system was not achieved until the meeting of major industrial countries at the meetings of the heads of state at Rambouillet, France, in November 1975. Agreement on the full reform package was secured at the meeting of the Interim Committee of IMF Governors at Kingston, Jamaica in January 1976. The Jamaica agreements accept floating exchange rates while reaffirming the importance of international cooperation and exchange rate stability.

B. Floating Exchange Rates in Operation

Assuming exchange rates are determined in a free market (no government intevention), the rate is determined solely by the supply and demand for dollars. If the supply of dollars is greater than the demand, the exchange rate will fall (i.e., the dollar will depreciate--one dollar will buy fewer units of a foreign currency). On the other hand, if the demand for dollars is greater than the supply of dollars, the exchange rate will rise (the dollar will appreciate or buy more units of a foreign currency).

1. The Role of the Dollar

In addition, the U.S. dollar plays a unique role in the international monetary system. Dollars, or dollar-denominated assets, are held as reserves by foreign central banks as well as by foreign firms and individuals and the dollar is used in payment among countries other than the United Staes as well as between the United States and other countries. Foreigners have acquired large amounts of dollars because U.S. payments abroad have exceeded U.S. recepts from abroad over a period of years.

Since the dollar was a strong currency which was accepted as payment by other countries and because the dollars held could be invested in safe, interest-earning assets such as U.S. Treasury bills, or placed in a dollar-denominated time deposit in a foreign bank (the Eurodollar market), foreigners have been willing to hold dollars. One result of the large accumulations of dollars by foreigners, however, is that whenever foreigners decide to sell dollars or dollar-denominated assets for foreign currencies, the supply of dollars on the foreign exchange markets increases.

2. Intervention in the Exchange Market

The only direct action central banks can take to influence exchange rates or to counter disorderly markets is to intervene in the foreign exchange markets by buying and selling dollars and foreign currencies. This can be accomplished either by foreign central banks or by the Federal Reserve System. For example, to prevent dollar depreciation, foreign central banks can intervene by buying dollars with their own national currencies.

If the U.S. decides to buy dollars, it can obtain foreign currencies from its stocks on hand, via swap arrangement (short-term agreements with foreign central banks to provide the Fed with a certain amount of that country's currency in exchange for dollars), by selling special drawing rights, by drawing on it reserve position in the IMF or by issuing foreign-currency denominated securities. The U.S. decision to intervene is made jointly by the U.S. Treasury and the Board of Governors of the Federal Reserve

System; the actual buying and selling of currencies is done by traders at the Federal Reserve Bank of New York.

C. Dollar Exchange Rate

The amount of depreciation (or appreciation) of the dollar differs substantially depending on which currencies it is measured against. In fact, the dollar may depreciate against one currency, while at the same time it is appreciating against other currencies. Over the past few years, the dollar's exchange rate has fluctuated most when measured against the Japanese yen, German mark, and Swiss franc.

To determine the overall depreciation or appreciation of the dollar, a trade-weighted average, in which the dollar is measured against an average of a number of currencies, each weighted by its share in U.S. trade, is used. It is likely that the dollar's fluctuations will be much smaller when measured against a trade-weighted average than against a single currency, since the former includes currencies that are both depreciating and appreciating against the dollar.

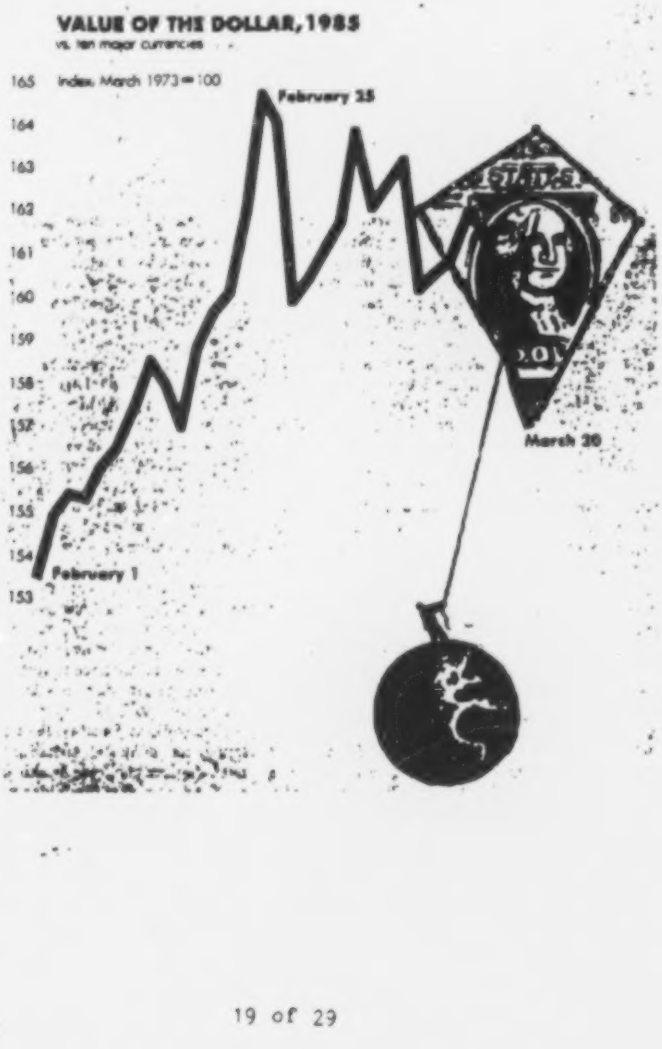
Exchange Rate Trends

Percent depreciation (-) or appreciation
in U.S. dollar relative to ---

	DM	Yen	Swiss franc	trade-weighted average
12/31/77 - 12/31/78	-13.4	-19.0	-18.9	-5.0
12/31/78 - 12/31/79	- 5.0	23.7	- 1.2	2.1
12/31/79 - 12/31/80	14.3	-15.4	11.8	0.7
12/31/80 - 12/31/81	13.8	8.2	0.3	6.5
12/31/81 - 12/31/82	6.2	6.6	12.3	8.6
12/31/82 - 12/31/83	14.2	- 1.1	8.7	5.3
12/31/83 - 12/31/84	15.8	8.6	11.9	11.3
12/31/84 - 03/15/85	7.2	3.6	10.5	NA

It should be noted that that dollar's fluctuations within years (not shown in the table) are sometimes greater than the year-to-year changes shown in the table. For example, the dollar's appreciation of six percent against the DM in 1982 reflects an appreciation of 16 percent between December 31, 1981 and November 8, 1982, and a depreciation of about eight percent between November 8 and December 31, 1982.

More recently, the dollar has experienced unusual volatility as illustrated in the following chart. During February 1975 the dollar appreciated 7.3 percent, reaching an all time high, before central banks intervened, causing the dollar to drop by six percent.



D. Causes of Exchange Rate Fluctuations

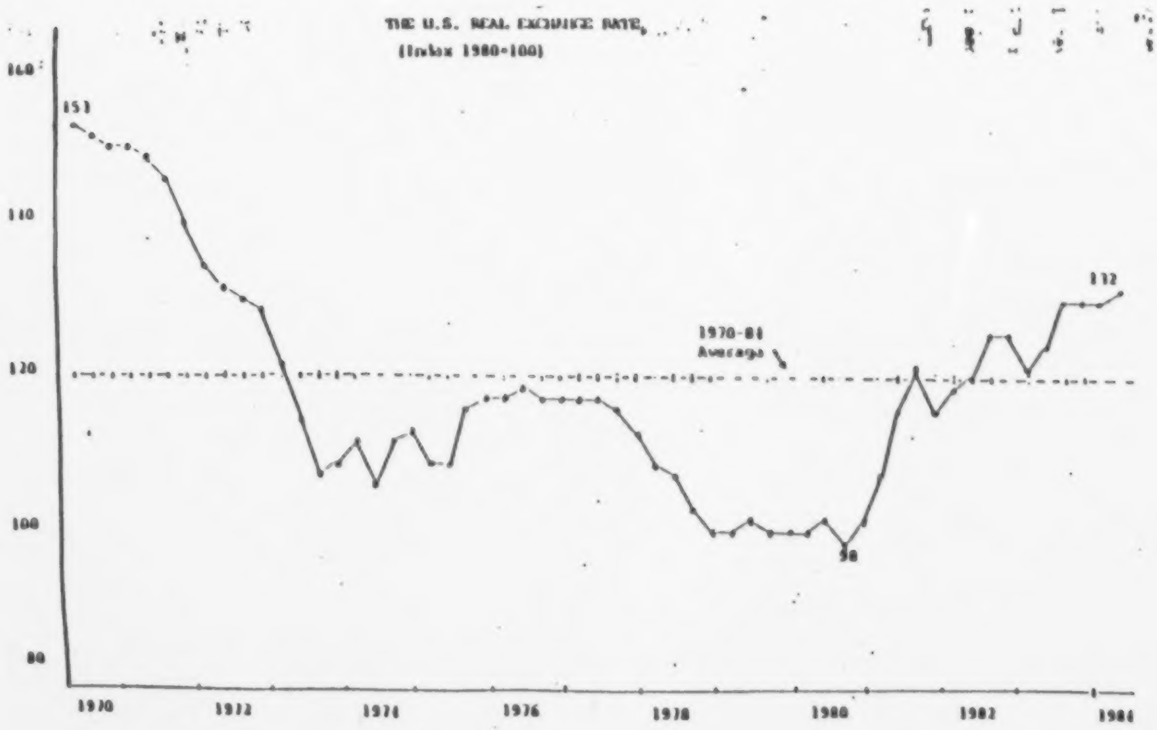
Although the exact causes of exchange rate fluctuations are not well understood, several factors are believe to be the most important determinants. These include the current account balances of different countries, relative inflation rates, relative growth of money supplies, relative interest rates, real income levels in different countries, and expectations of future exchange rate change. There are different theories regarding how these factors affect exchange rates, however, and empirical tests of the various theories have yielded inconclusive results.

Generally, in the early 1970s, when the floating exchange rate system was established, it was thought that exchange rates were determined mainly by trade flows (capital flows were relatively small and often restricted). Trade flows, in turn, were thought to be determined mainly by relative real incomes and relative prices. For example, according to this theory, if real income in the United States increases relative to that abroad, U.S. imports will increase, leading to a worsened U.S. current account balance, an increased supply of dollars on foreign exchange markets and a dollar depreciation. Or, if U.S. prices fall relative to those abroad, U.S. exports will increase, U.S. imports will decrease, the U.S. current account will improve and the dollar will appreciate.

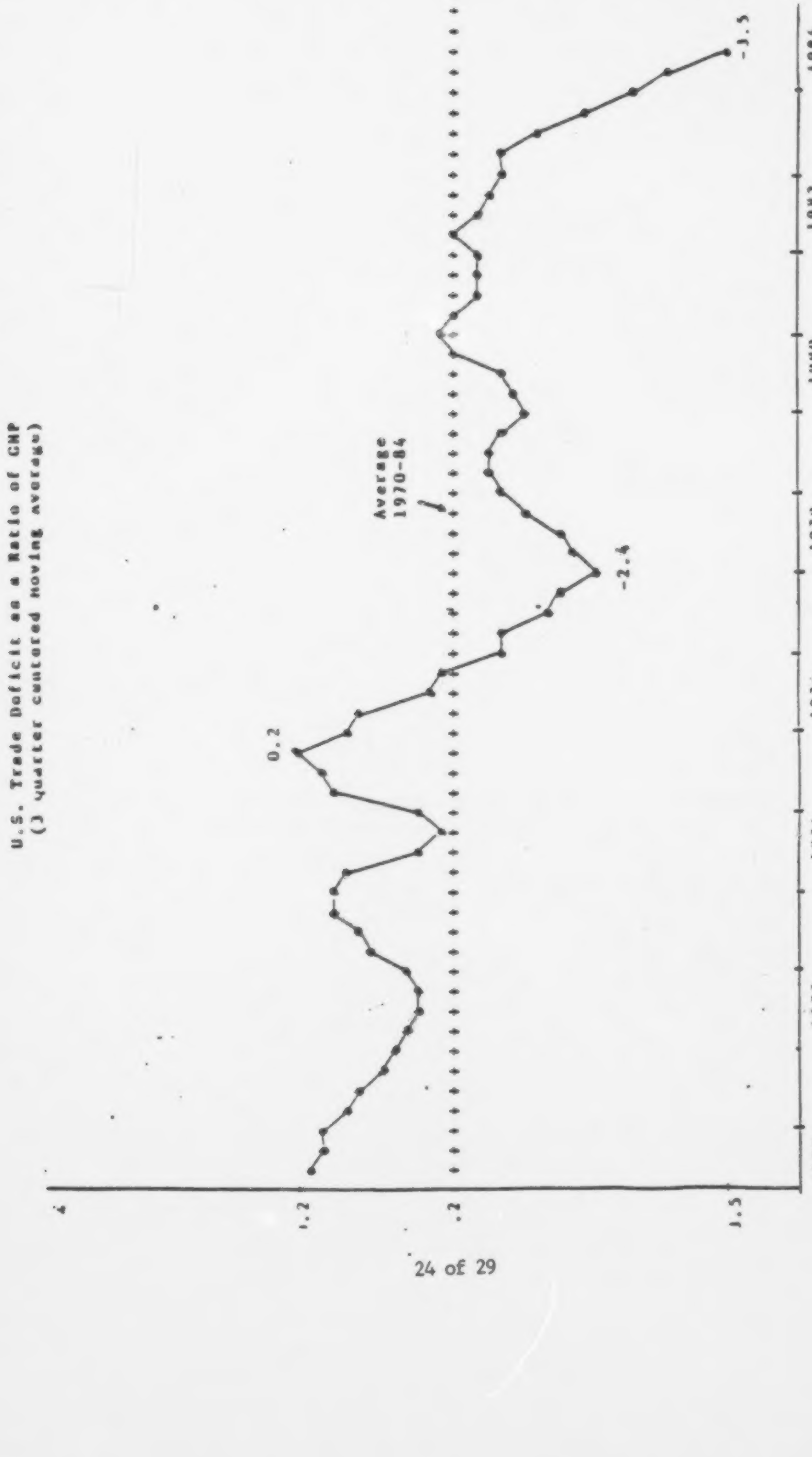
In recent years, however, capital flows have increased substantially and most analysts believe they are an important, and perhaps the major, factor in the determination of exchange rates, at least in the short run. For example, a foreign exchange survey by the Federal Reserve Bank of New York shows that foreign exchange transactions in the United States were about ten times the sum of annual U.S. exports plus imports in 1983. It is estimated that $20 to $30 trillion in capital now moves through foreign exchange markets each year compared with about $2 trillion in annual trade in goods and services.

IV. TRADE CONSEQUENCES OF DOLLAR APRECIATION

Most observers agree that the appreciation of the dollar since 1979 has had a major and negative effect on the U.S. export competitiveness and has similarly improved the competitiveness of foreign products exported to the U.S. The following two tables suggest that the U.S. trade deficit grows with dollar appreciation and shrinks with dollar depreciation.



THE U.S. REAL EXCHANGE RATE,
(Index 1980=100)



U.S. Trade Deficit as a Ratio of GNP
(3 quarter centered moving average)

The following table indicates that the U.S. net loss of competitiveness relative to Japan during 1980-1981 was about 28 percent, and 50 percent relative to Germany (and much of Europe).

U.S. Loss of Export Competitiveness in Manufacturing
(Cumulative Percentage Change of Dollar Prices: 1980-84:I)

	U.S.	Japan	Germany
Machinery and Transport Equipment	21.5	-4.7	-18.9
Electrical Machinery, Apparatus and Appliances	20.7	-2.2	-18.8
Non-Electrical Machinery	12.4	-8.8	-19.6

Source: UN Monthly Bulletin of Statistics.

This change in competitiveness, together with cyclical factors, have worked in opposing directions for the U.S. and for foreign countries.

Change in Trade Volume
(Cumulative Percent Change: 1982-84

	U.S.	Europe	Japan	Latin America
Exports	-15.0	15.0	30.3	26.4
Imports	21.0	6.2	5.0	-31.6

Source: IMF World Economic Outlook

IV. EXCHANGE RATES WITHIN THE LEGAL FRAMEWORK OF THE TRADING SYSTEM

A. The GATT

The General Agreement on Tariffs and Trade is based on the Bretton Woods system. No recognition is given the post-1973 floating exchange rate system. For example, Article II.6 of the GATT notes that tariffs are to be expressed in the appropriate currency at the "par value" recognized for that currency by the IMF. Similarly, Article XII establishes the balance of payments conditions pursuant to which a member may impose quantitative restrictions on imports. The conditions are based on the state of a country's monetary reserves, a measure rendered largely obsolete in a floating exchange rate system where a country does not choose to defend any particular value for its currency by drawing on its monetary reserves.

B. U.S. Trade Laws

As a result of the challenge to the legality of President Nixon's 1971 import surcharge, Congress enacted a balance of payments provision as part of the 1974 Trade Act.

Although the President's authority to impose an import surcharge was ultimately upheld by the courts, the section 122 balance-of-payments authority was included in the Trade Act of 1974 to insure that the President had such authority in a future crisis. That section authorized the President to impose, for up to 150 days, an import surcharge of up to 15 percent, or quotas, or both, in the event of a large U.S. balance of payments deficit, the threat of a sudden drop in the dollar's value or the need to cooperate with other countries in correcting balance-of-payments disequilibrium. Another paragraph of section 122 permits the President to reduce tariffs temporarily and take other actions to deal with U.S. surpluses. The President was directed to seek modification of international agreements with the purpose of permitting the use of surcharges in place of quantitative restrictions. The surcharge was seen as a balance-of-payments adjustment measure within the context of arrangements for an equitable sharing of balance-of-payments adjustment responsibility among deficit and surplus countries.

Pursuant to the directive of section 122, the U.S. negotiated an agreement on trade measures taken for balance-of-payment purposes as part of the Tokyo Round of negotiations concluded in 1979. The effect of the "Declaration on Trade Measures taken for Balance-of-Payments Purposes" was to give preference to surcharges over quotas, to the extent the circumstances described in GATT article XII were present. The Declaration made it clear that trade measures were not regarded as an efficient means of restoring balance of payments equilibrium, and that, should tariffs be used in place of quotas, the procedural requirements of Article XII for consultation and otherwise had to be followed.

In testimony before the Finance Committee last year, Martin Feldstein, then Chairman of the Council of Economic Advisers, testified that section 122 was a dead letter in light of a floating exchange rate system which has rendered the concept of a balance of payments deficit obsolete.

V. CONCLUSION

Some of the worst fears of the framers of the Bretton Woods system have materialized under the floating exchange rate system. Massive, and arguably speculative, capital flows of unprecedented size now determine exchange rates. Exchange rates have become more volatile. Huge trade and current account disequilibria have spawned protectionist pressures.

The rules of the trading system were designed in the context of the Bretton Woods system, a system designed to avoid disequilibrium. The breakdown of that system and the evolution of floating exchange rates raises the question of whether the trading system needs to adjust to the new exchange market reality. Over forty years since the Anglo-American "founding fathers" met at Bretton Woods, the old dilemma facing them remains - if you don't manage money, at least in some degree, won't you have to manage trade?

Senator DANFORTH. Ladies and gentlemen, a number of months ago, some 34 Senators introduced S. 1860. It is a very comprehensive bill, relating to a number of aspects of U.S. trade policy. One of the sections of the bill deals with the issues of the exchange rate and Third World debt and the effect which exchange rates and Third World debt have on international trade.

It is clear to everyone who has observed the trade scene that the problem of our large trade deficit is not only a problem of unfair trade practices, but it is also a problem of general economic conditions in the United States and in the rest of the world. Last year, the value of the dollar was extraordinarily high compared with other currencies, particularly the yen.

In addition to that, whereas in the past the United States has been very reliant on its ability to sell approximately 40 percent of our exports to less developed countries. The existence of huge and growing amounts of debt in less developed countries has meant that our markets have deteriorated significantly.

Other countries, especially in Latin America, have attempted to ease the debt burden at the urging of the International Monetary Fund and others by reducing imports and by stressing exports as a way of simply paying the interest on the debt.

These questions of the exchange rate and international debt are the subject of a portion of S. 1860 and also S. 1866, which is the specific bill dealing with these economic matters. Senator Bradley and Senator Mattingly have been leaders in this area. Senator Mattingly hopes to be here a little later. Of course, the Secretary of the Treasury is going to be here, about a quarter of eleven.

I want to just state my own view, that while economic concerns are extraordinarily important in the trade area, these are a part of the problem, not the whole problem.

With respect to Japan, if a country has a currency, which is valued low compared to the yen, that country still has difficulties of getting into the Japanese market.

My own view is that in order to try to get a handle on the trade problem, we have to approach everything at the same time. We have to approach the exchange rate problem. We have to approach the Third World debt problem. We have to approach unfair trade practices. And, obviously, U.S. industry and U.S labor has to be in a position of producing competitive products at competitive prices.

All of these have to come together for an effective trade policy.

Senator Baucus.

Senator BAUCUS. Mr. Chairman. I think it is clear, that there are a lot of factors, which cause our trade deficit. You enumerated some of them. Obviously, the historical, high U.S. dollar is one. Unfair trade practices by other countries and to some degree, our own contribute. Third is certainly our lack of competitiveness and relatively low rate of productivity growth in this country.

All of these contribute to our adverse trade deficit and have something to do with the reason why our economic performance in this country is not otherwise better. It should be.

Nevertheless, I think it is important to focus one at a time on certain problems that face us. The one that comes to my mind is the subject of the recent Joint Economic Committee report, which very directly questions America's policy with regard to Third

World countries and the extent to which United States commercial banks loan to Third World, particularly, Latin American countries.

That report dramatically shows that recent administration policy in conjunction with the IMF and the World Bank have encouraged very high rates of loans to Third World countries. And the banks have charged very high spreads. The basis points are rising from 85 basis points in the early 1980's to an average lately of 125 basis points, greatly increasing the profits of the big banks, but unfortunately hurting American farmers and ranchers who are trying to export products to Third World countries.

U.S. agricultural exports have declined from about $43 billion in 1981 to roughly $29 billion in total agricultural exports last year. At the same time, these IMF and World Bank policies not only hurt American farmers and ranchers, but some commodity producers in this country, including certainly, our copper industry. They also have not helped Third World countries like Brazil, Argentina, and Mexico.

In fact, studies show, that the poverty in those countries has not declined, it has increased. People in those countries suffer from increased malnutrition. And, the prospect, too, is for greater and greater debt service burdens in the future.

I think it is somewhat ironic, Mr. Chairman, that the administration that preaches free trade intervenes to help the big banks. And, ironically, it has hurt small banks, the country banks. They have been left to fend for themselves. I hope these are questions that the Treasury Secretary will address, when he appears before us.

It is important, I think to focus on the problem that is now facing us. The second major problem is, what is the U.S. policy on exchange rates? To what degree is the United States going to intervene or not intervene. What are our standards? What are our criteria? How far should the dollar decline? What is our policy? That has not been clearly spelled out at all. I think Americans deserve to know more precisely what that policy is. I hope that, Mr. Chairman, at the conclusion of this hearing, we have a little better idea, after we hear from the administration.

Senator **Danforth**. Thank you, Senator Baucus.

Any further opening statements?

Senator Mitchell.

Senator **Mitchell**. Mr. Chairman. I thank you. My statement involves the overall legislation, which I understand this is part of. And which, hearings will continue for some time. I commend you, Mr. Chairman for this action, because our consideration of trade reform comes at an important time.

Just 2 weeks ago the Commerce Department reported that the U.S. trade deficit continues to grow at a record pace. In each of the past 5 years, the U.S. trade deficit reached a new record level, rising from $39 billion in 1981 to $148 billion in 1985.

Figures for January through March of this year show the trade deficit growing at an annual rate of over $170 billion, another new record. These numbers convey an enormous toll in human terms. Jobs continue to be lost, lives continue to be disrupted and the American industrial base continues to erode. Most of these jobs will never return.

But, despite these indicators, indicators that have extended over 5 years, the administration has remained unconcerned about the need for fundamental reform of our trade laws.

Over the past 5 years, it has become clear that the Reagan administration views trade policy with ideological blinders. Any action that gives American firms recourse against distorted foreign trade practices is immediately branded as "protectionist." Trade policy is thus polarized into two extremes; on the one hand, free trade, which implies utter noninterference, and on the other hand, protectionism, the label with which, this administration characterizes anything which involves altering markets in any way, even if it means correcting a foreign-induced distortion.

It is becoming increasingly apparent that the administration's trade policies are simplistic and specious. The notion of comparative advantage in markets implies that each trading partner plays by the same rules domestically, and that comparative advantage, therefore, is determined by true market forces. Unfortunately, that is not the way international trade takes place in the world today. Time after time, case after case, sector after sector of our economy, American economies must compete in free markets, while their foreign competitors benefit from an array of assistance programs, subsidies and import barriers.

This assistance confers an artificial comparative advantage, yet, the administration is willing to let American firms wither because of these unfair foreign advantages. It makes more sense for this country to offset foreign induced distortions, rather than to accede to them. An aggressive policy of credibly counteracting unfair foreign trade practices is not only fair and prudent, but in the longer term would reduce the incentives for out trading partners to pursue such distorted practices. In this way, we may ultimately approach a world of truly fair and free trade.

But, in order to ensure a more aggressive and sensible trade policy, we need to reform American trade law. We need to make our response to unfair trading practices less subject to foreign diplomatic pressure. We need to strengthen access to trade law remedies. We must guarantee that those, who are the victims of distorted foreign trade practices actually receive relief. The administration has shown itself wholly unwilling to assist American producers affected by such practices. By reforming our trade laws, Congress can act, where the administration has refused to act.

I thank you, Mr. Chairman.

Senator DANFORTH. Further opening statements? Senator Bentsen.

Senator BENTSEN. Mr. Chairman, I certainly commend you on these hearings. I hope this is the beginning of a process that will result in comprehensive trade legislation and reform. I also want to commend Secretary Baker, who is going to testify this morning on the currency exchange agreements that were reached at the Tokyo summit.

I view these agreements as significant accomplishments—seven nations agreeing to intervene to keep the value of their currencies in line with economic conditions. It is a very positive and a very helpful step.

But, you know, I remember introducing trade legislations with a lot of my colleagues last summer that called on the Secretary of the Treasury—and I quote specifically what it stated—"to design a plan for a coordinated, multinational effort to minimize exchange rate fluctuations." Now, those were the specific words that were used last year. So, what happened? The administration dismissed those calls for currency interventions a year ago. They said, "A strong dollar is not a problem, but it is a blessing, a sign that our economy is really strong."

So, I am most pleased with this 180-degree change in direction. In fact, I remember that the legislation was dismissed as rank protectionism. Senator Mitchell, you talk about protectionism being the answer here. It was dismissed as rank protectionism by the administration.

But, I am still concerned about the administration's attitude toward trade, with that $150 billion trade deficit we had last year. Now, if you average out our trade deficit for the first 3 months of this year as Senator Mitchell has stated, we are looking at $170 billion. I hope it does not come to that.

I hope this currency intervention will begin to moderate that situation in the months ahead and see the deficit somewhat reduced. But, even so, we are going to find trade barriers that we are going to have to overcome.

What really concerns me is that this administration does not have a coordinated trade policy. It does not really show any interest in developing one. What they have done on currency was to say, "Let the marketplace take care of it, we are not going to intervene, we're not going to take any action." They have done the same thing on trade.

If they will make the 180-degree change in direction on trade that they have done on currency intervention, perhaps we will begin to make some headway. There is a lot of talk about free trade, but they do not do anything to promote it. We do not have a free trade policy in this country. If we did, we would be doing something about the rising walls of protectionism that are shutting out our products in other countries. We do not have a free trade policy; we have a hands off policy.

The little time this administration devotes to trade is spent worrying aloud about protectionist pressure in the United States. Nothing is said, certainly nothing is done, about the rising tide of protectionism in country after country around the world. The administration refuses to be concerned about a $150 billion trade deficit.

Its only real concern is that that deficit is going to increase protectionist pressures in Congress. They declined to admit that a $14.5 billion trade deficit in March was a problem. In its eyes the only problem is—again—that the deficit is going to increase the protectionist fever in Congress.

I would say to the administration that there is indeed a real sentiment in Congress, there is a fever, there is an increasing pressure, all of those things. But, it is for action to have open markets around the world, markets that are closed to us. And, that is not protectionism.

Look what we see from the administration now: continued refusal to admit the problem and speak to it; continued refusal to develop an effective, coordinated trade policy. If, we keep that up, it will surely lead to protectionism.

Mr. Chairman, again, I hope this is a start of trying to develop a coordinated trade policy. I congratulate you on the hearings.

Senator **Danforth**. Thank you. Senator Grassley.

Senator **Grassley**. Mr. Chairman, besides putting in a long statement in the record, I would like to say that my view is that we have too many trade policies as opposed to a unified national trade policy.

We respond too often to crises, which is not the way to respond. We ought to have a policy to avoid crises.

Second, we find too often the President reacting to what we in the Congress might propose to do and finding him on the defensive. And that sends a signal of a disorganized trade policy. And, too often we have so many different spokesmen for our trade policy. Secretary Baker will have a program, a piece of the puzzle. Ambassador Yeutter will have another role to play and another approach to take. The Secretary of Commerce, yet another one.

And, I think we have sent a signal to our friends around the world who are our competitors in international trade, that we really do not know what we are doing or what we want. And, that is not a very good signal to send. And, if out of these hearings comes some sense of direction of the U.S. Government having a unified national trade program, then I think some good will come. But, I do not think that we have sent a very clear signal of what our goals are.

There is one positive thing, that I have seen on the horizon in just the last month or two, directly related to agriculture in the United States and particularly my State, that exports so much of our agricultural products. It has been good for me to hear the Secretary of State, when he was recently in Europe, emphasize the necessity of an agreement with the European Community on agricultural trade. Also, to see the President of the United States have this on the agenda in Tokyo recently. And, to see Ambassador Yeutter to a greater extent than before, push for a stronger—for America's interest, stronger trade negotiations than before.

But, each of those still signal a disjointed unified policy for our country. We have to get our act together and to tell the world we know where we are going. But, before we can do that, we ourselves have to figure out where we want to go.

Senator **Danforth**. Senator Chafee.

Senator **Chafee**. Thank you, Mr. Chairman. I differ with the views expressed here by some. I think that the administration has been a bulwark against this country going protectionist. When there was legislation passed in the House dealing with domestic content and automobiles, who stood up? It was the administration of this country that stood up against a disasterous policy.

There is room for criticism. I am not going to be one, that is going to sit here and lambast the administration, which I think has done a fairly good job, overall. I have my share of criticisms. I think the failure to enact a reciprocity policy against those countries that deny us market access is wrong. And, that is one thing that we have been trying to do here, particulary in this trade legislation, we are working on now.

If a country will not let in our goods, then we ought to deny that country access to our markets. And, indeed, I introduced legislation, specifically, on telecommunications to achieve that result. But, it is clear, that given its way, this Congress would have gone a protectionist route. We might as well acknowledge it. The administration has been holding up against that process which I believe would be disasterous for our country in the long run.

Now, as for the decline in the value of the dollar, I am gratified this decline has taken place. Frankly, I do not think it is going to lead to all the wonderful things we think of. Those countries that now have a piece of our market are not going to willingly give that up, just because the yen has declined against the dollar or because, the dollar has weakened against the deutsche mark or whatever currency it might be. And, if Brazil has gone to tremendous effort to get into the orange business, they are not going to be pried out, just because times have changed.

So, I think we have got a lot of troubles still ahead for us in doing something about this imbalance in trade. One of the things we have to do is get our act in order. And, it is not all legislation. It is every worker and every businessman in this country, realizing they have got to produce a quality product. And, that is something we have failed to do.

Automobile companies are now making a major effort in that direction. It is high time they did. Right from the President and chairman, down to the fellow in the assembly line. So, it is easy to throw blame around and blame the other countries. Blame the administration, but sometimes, it is ourselves. That is, the average American, that needs to hitch up his trousers and get to work. And, I hope we can continue to do that and I look forward to this legislation, Mr. Chairman, and the effort you're making.

Senator DANFORTH. Thank you, Senator Chafee.

Senator Dixon would you like to praise or blame the administration?

Senator DIXON. I have placed my statement.

Senator DANFORTH. Thank you very much.

The first witness is Senator Mattingly.

[The prepared written statement of Senator Dixon follows:]

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I am pleased to be here this morning as the International Finance Subcommittee of the Senate Banking Committee jointly conduct a hearing on trade, exchange rate, and LDC debt issues. I look forward to hearing from our distinguished witness, Secretary of the Treasury Baker. I always appreciate the opportunity to hear his views and recommendations on vital trade, international finance, and other economic issues.

I want to take this opportunity to congratulate the Secretary for his accomplishments at the Tokyo Summit. The agreement on economic cooperation and policy coordination is good news to me and to the people of Illinois. The imbalance in past policies that led to the high value of the dollar extracted a painful price in lost manufacturing jobs and increased the hardships facing the Nation's farmers.

It is encouraging that we will attempt to work more closely with our allies to open up markets for trade and to stabilze exchange rates by coordinating our policies. I believe the Toyko communique rightly focuses on the need for bringing the industrial nations' economic goals and policies into better alignment. It is this cooperation that holds the best promise for a more balanced international economy and more stable exchange rates.

I hope the Secretary's testimony will cover the role international monetary and fiscal policy coordination can play in helping to ensure a stable exchange rate environment, as well as the role that direct intervention can and should play. I believe government intervention has a place, but intervention cannot be used successfully to set exchange rates at levels not dictated by economic fundamentals. Given the huge volume of international trade and the even larger volume of international financial transactions, direct intervention clearly cannot set exchange rates. There are occasions when timely and appropriate intervention can influence rates by helping the markets to recognize some underlying economic realities. Its influence, however, is most effective, if it used correctly, and not overused. I would be very interested in hearing the Secretary's comments on this subject, and his view of what the Tokyo agreement calls for in this area.

STATEMENT OF HON. MACK MATTINGLY, A U.S. SENATOR FROM THE STATE OF GEORGIA

Senator MATTINGLY. Thank you, Mr. Chairman. I was sitting here listening to everybody talk and I listened to Senator Chafee talk about hitching up his trousers. That would be fine as long as they were made in the U.S.A. [Laughter.]

I would like to thank the chairman for holding a joint meeting, between the Banking Committee and Finance Committee, in reference to S. 1860. I think these hearings have long been anticipated by this Senator. And, I appreciate the effort necessary to schedule consideration of this legislation, during what has been really an action-packed period for the Finance Committee members.

Senate consideration of trade legislation is a must. And, hopefully, we can now begin to generate the momentum necessary to act. S. 1860, the legislative package that will be examined in this series of hearings, is vital to our country's social and economic well-being.

Last November, I joined with Senator Bradley and others to introduce S. 1866, a bill to establish U.S. policy on exchange rates and developing country debt. As you know, Mr. Chairman, S. 1866 is also incorporated into the Trade Enhancement Act as title 5.

Our intent was to address two areas, that for some time have been the discussion of much discussion, but very little action or organization. We were encouraged by the administration seeming policy change as represented by the Plaza meeting, early in the fall and the aggressive treatment of lesser developed countries debt advocated by the Baker plan and felt there was a definite need to set out U.S. policy parameters in two areas—exchange rate volatility and Third World debt—as part of any broader trade policy effort in the Congress. There can be little doubt, that exchange rate instability and enormous Third World debt loads have as direct an impact on our trade performance, as the unfair trading practices addressed by section 301 of the Trade Act or the regulation of U.S. marketing practices overseas.

Title 1 of the Trade Enhancement Act, S. 1861, of which I am the author, clearly illustrates the complexity of factors influencing U.S trade policy and the necessity of a policy that is thorough, yet pragmatic in its approach. While improving specific trade laws, we must also attempt to address the more macroeconomic issue of the state of the global economy and it's impact on international trade flows.

Title 5 first sets out U.S. policy on exchange rates. It says coordination of monetary and fiscal policy is necessary if imbalances in trade and capital flows are to be eliminated and exchange rates stabilized. Coordination of central bank participation in international currency markets is a reality, supported by the agreement reached during the Tokyo economic summit. The title provides authority to carry out these policy goals and means to moderate exchange rate fluctuations. This process is a delicate one, dependent on the cooperation of seven nations.

We have experienced the reluctance of Japan and West Germany to heat up their economies and I keep in mind concerns, such as Chairman Volcker's, that we had best make sure that dollar decline remains manageable. The concerns, however, should not make us afraid to act nor rigid in proposals such as the one before us today.

Title 5 also makes very clear it is in our best interest to support the revitalization of the developing nations' economies. These countries can provide enormous market opportunities for U.S. goods and services, yet the crushing debt burden of these countries is just that, crushing. Desperate for the foreign exchange necessary to pay just the interest on their loans, the developing nations embarked on a destructive export-focused economic policy, just to keep their heads over water. But the water is continuing to rise and there are those, who are in danger of sinking. If not the debtors, then the bankers who loaned the money; If not the bankers, then the U.S. producers who find that their markets are disappearing.

Now, how best to address this problem of developing country debt. Title 5 would encourage the adoption of pragmatic economic policies in these countries, by providing financial incentives in the form of increased Export-Import Bank loan guarantee authority and additional leveraging for World Bank loans. Keep in mind that the above are incentives that would be available only to those countries who remove their trade and investment barriers and who offer economic growth opportunities to the private sector that are equal to those available in the private sector.

Finally, I think we have seen the disasterous results of continued expansion in areas of global overproduction such as mining and agriculture. Title 5 would authorize the President to enter into negotiations with members of the OECD and the multilateral development banks to prohibit funding of such unproductive use of resources. I wish I could stay to hear the Secretary's update on his proposal regarding LCD debt.

Mr. Chairman, I promised I would be brief. I will close by saying I cannot emphasize enough the importance of establishing a coherent U.S. trade policy that addresses, in realistic fashion, the trade problems of today. I have said it a hundred times before and I am going to say it here again: We must speak with a single voice on trade and a voice that follows a unified, a coherent policy that affords long, not short term, economic growth and well-being of this country. That voice must firmly seek the establishment of a fair and open-market system that provides the trade access necessary to all trading nations. We in the Congress should guide that voice, in effect serving as the trade conscience of our trade policy. We in the Congress should work to firmly provide a well thought out framework within which our trade officials can and must act.

We have seen, I believe, over 300 pieces of trade legislation introduced in this Congress. Most have only offered a sort of shotgun-type approach to trade policy. S. 1860, the Trade Enhancement Act of 1985, is a framework for what I call a rifle-type approach, more sophisticated and accurate, that can really create a trade policy for our country.

Mr. Chairman, I urge speedy and favorable Finance Committee action on this vital piece of legislation. I hope you do as well on this as you did the tax reform legislation.

Senator DANFORTH. Thank you very much, Senator Mattingly. We appreciate your testimony.

Senator MATTINGLY. Thank you.

Senator DANFORTH. I know that you are on the run. Does anyone have any questions for Senator Mattingly?

[No response.]

Senator DANFORTH. Thank you very much for your testimony.

Senator MATTINGLY. Thank you, Mr. Chairman.

[The prepared statement of Senator Mack Mattingly follows:]

TESTIMONY OF SENATOR MACK MATTINGLY

To the two cochairmen I would like to say what a pleasure it is to appear before you here today. These hearings have long been eagerly anticipated by this Senator and I appreciate the effort necessary to schedule consideration of this legislation during what has been an action-packed period for Finance Committee members. I feel Senate consideration of trade legislation is a must and am hopeful that we can begin to generate the momentum necessary to act.

S. 1860, the legislative package that will be examined in this series of hearings is vital to our country's social and economic well-being. Last November I joined with Senator Bradley and others to introduce S. 1866, a bill to establish U.S. policy on exchange rates and developing country debt. As you know S. 1866 is also incorporated into the Trade Enhancement Act as title five. Our intent was to address two areas that for some time had been the subject of much discussion, but very little action or organization. We were encouraged by the administration's seeming policy change as represented by the "plaza meeting" earlier in the fall and the aggressive treatment of lesser developed country (LDC) debt advocated by the "Baker plan" and felt that there was a definite need to set out U.S. policy parameters in two areas—exchange rate volitility and third world debt—as part of any broader trade policy effort in the Congress. There can be little doubt that exchange rate instability and enormous third world debt loads have as direct an impact on our trade performance as the unfair trading practices addressed by section 301 of the Trade Act or the regulation of U.S. marketing practices overseas. Title one of the Trade Enhancement Act (S. 1861), of which I am the author, clearly illustrates the complexity of factors influencing U.S. trade policy and the necessity of a policy that is thorough yet pragmatic in its approach. While improving specific trade laws we must also attempt to address the more macroeconomic issue of the state of the global economy and its impact on international trade flows.

Title five first sets out U.S. policy on exchange rates. It says coordination of monetary and fiscal policies is necessary if imbalances in trade and capital flows are to be eliminated and exchange rates stabilized. The coordination of central bank participation in international currency markets is a reality supported by the agreement reached during the Tokyo Economic Summit. The title provides authority to carry out these policy goals and the means to moderate exchange rate fluctuations. This process is a delicate one, dependent on the cooperation of seven nations. We have experienced the reluctance of Japan and West Germany to "heat up" their economies and I keep in mind concerns such as Chairman Volcker's that we had best make sure the dollar's decline remains manageable. The concerns, however, should not make us afraid to act nor rigid in proposals such as the one before us today.

Title five also makes clear that it is in our own best interest to support the revitalization of the developing nations' economies. These countries can provide enormous market opportunities for U.S. goods and services yet the crushing debt burden of these countries is just that—crushing. Desperate for the foreign exchange necessary to pay just the interest on their loans, developing nations embarked on a destructive export-focused economic policy just to keep their heads above water. But the water is continuing to rise and there are those in danger of sinking—if not the debtors then the bankers who loaned the money; if not the bankers then the U.S. producers who find that there markets are disappearing.

How best to address this problem of developing country debt? Title five would encourage the adoption of pragmatic economic policies in these countries by providing financial incentives in the form of increased Export-Import Bank loan guarantee authority and additional leveraging for world bank loans. Keep in mind that the above are incentives that would be available only to those countries who remove their trade and investment barriers and who offer economic growth opportunities to their private sector that are equal to those available to the public sector.

Finally, we have seen the disastrous results of continued expansion in areas of global overproduction such as mining and agriculture. Title five would authorize the President to enter into negotiations with members of the OECD and the multilateral development banks to prohibit funding of such unproductive use of resources. I am anxious to hear Secretary Baker's update on his proposal regarding LDC debt.

Mr. Chairman, I promised I would be brief and I will close by saying that I cannot emphasize enough the importance of establishing a coherent U.S. trade policy that adresses, in a realistic fashion, the trade problems of today. I have said it hundreds of times before and I will say it again here today: we must speak with a single voice on trade and that voice must follow a unified and coherent policy that affords long, not short, term economic growth and well-being for this country. That voice must firmly seek the establishment of a fair and open market system that provides the trade access necessary to all trading nations. We, in Congresss, should guide that voice—in effect serving as the trade conscience of our trade policy. We in Congress should work to firmly provide a well-thought out framework within which our trade officials can and must act. S. 1860, the Trade Enhancement Act of 1985 is that framework. Mr. Chairman, I urge speedy and favorable Finance Committee action on this vital legislation. Thank you.

Senator DANFORTH. Secretary Baker is due here in maybe 5 or 10 minutes or less. He is not here yet. My suggestion is that we proceed to hear from Professor Sachs. And, then, maybe Professor, we could interrupt your testimony before we get to the question part of your testimony if Secretary Baker arrives.

Professor Sachs is Jeffrey Sachs, professor of economics at Harvard University.

STATEMENT OF JEFFREY D. SACHS, PH.D., PROFESSOR OF ECONOMICS, HARVARD SCHOOL OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Professor SACHS. Thank you very much, Mr. Chairman. And, thank you for the opportunity for me to testify today on the developing country debt crisis. My testimony describes in some detail—I think that there are some very market strengths in the current approach of this Government, this administration, to the developing country debt crisis. But, there are also several dangers. And, those dangers are severe, they are showing in many ways right now. And, I also do not feel that they are adequately addressed in the legislation, now before the committee.

The strengths of the current approach are that it properly treats the debt crisis on a case by case approach, because, indeed the debtor countries of this world are very different in their economic circumstances and it is justified, that that case by case approach be continued.

Second, the current approach focuses on conditionality, which is also thoroughly appropriate in this context. The developing country debt crisis is a cautionary tale. It is clear the more deeply we study how the countries got into this problem, that the answer is fairly simple. The governments in the over indebted countries simply borrow too much. They ran large, indeed enormous budget deficits for over a decade, in almost every case of a country now in debt crisis.

Because, the main reason for the debt crisis, then, is serious policy mistakes in the borrowing countries themselves. The focus on conditionality, I believe is thoroughly appropriate. The major weakness, however, with the current approach is that there are no safety valves. The approach is predicated on the notion, that all interest due to commercial banks will continue to be serviced at market interest rates.

Of course, principal can be rescheduled, new official credits can be provided, but interest servicing to commercial banks will be continued at commercial rates. I believe that this is a serious mistake as to adopt as a general principle, and it will prove in future years to be unworkable. My testimony focuses on the need for debt relief, which I believe is showing in a very serious way in many countries in Latin America, right now.

It is clear, that the approach, which insists on current payments at market interest rates for all interest servicing has led to remarkable austerity. A decline in markets for U.S exports and an outbreak of hyperinflation throughout the hemisphere. As you may be aware, Bolivia for instance, reached 50,000 percent inflation last year. Brazil topped 500 percent before a new plan was instituted. Argentina topped a 1,000 percent, and Peru over 200 percent.

These countries are at a breaking point.

Senator **Chafee**. Did you say, 50,000?

Professor **Sachs**. Yes, I did. The highest inflation——

Senator **Chafee**. Is that the record?

Professor **Sachs**. It is the seventh highest in the world history.

Senator **Chafee**. Who holds the record?

Professor **Sachs**. Hungary, after World War II. I cannot even—there is not a name for the number, 10 to the 175th power, for the Hungarian inflation. Prices tripled every day for several months.

Bolivia did not reach that, but the point is, that these countries are crumbling. Several of them are on the verge of political and social collapse. Peru is a very instructive case. The society is falling apart. Terrorism, kidnaping, murder are the daily fare of Lima these days. There is massive capital flight. The drug business is the only profitable activity in the country, because of the collapse of the domestic economy.

And, yet, the administration and the world financial community has regarded it as an affront, when President Garcia cried out to the world of his need for debt relief. I think in that case it is clear that the countries have been pushed to far, when we are pushing them over the brink of social collapse.

Secretary Baker's initiative on the debt crisis is certainly a salutary step right now, but I do not think that it is a long-term solution in any way. The money is simply, too small, it might not even materialize the parts from the commercial bank.

Liberalization, which is important for these countries is a long-term solution, not a short-term solution. And, there is no escape from the fact, that unless there is debt relief, austerity in terms of the budgets of these countries will have to continue.

There is not a distinction between World Bank pro growth and IMF austerity in a situation, where you can not get more money to the countries. The austerity is simply a reflection of the lack of resources available to the governments of the region. Since they do not have foreign resources they are printing money like crazy. They are succumbing to hyperinflation, but we can not get away from austerity until there is more foreign money or debt relief.

Since, I do not think a lot of new foreign money is in the offering, I think that we have to very seriously look at the question of debt relief. Now, the whole history of borrowing experience from developing countries over the last two centuries is that there have been repeated instances of debt crisis followed by some debt relief, very much like chapter 11, corporate reorganizations.

I think that it is clear here, that we should give much more thought in that direction. I have done calculations as to what serious debt relief would mean for the commercial banks. I believe it is manageable, even if all of the $20 billion that Secretary Baker has identified as new commercial bank lending were in the form of grant or interest relief, rather than debt relief.

It would involve perhaps a reduction in value relative to equity of about 7 to 7½ percent of bank equity. Which sounds like a lot until one reflects on the fact, that the stock market has already written down this debt to a tune of 0.20 on the dollar or 0.25 on the dollar. So, bank stock prices already reflect an anticipated write-down in the value of the loans in the excess of the amount that would be made—that could be established directly as a grant.

Indeed not all of the countries on Secretary Baker's list need that relief. I think that the four that are clearly crying out for it in terms of the state of their economies are Argentina, Bolivia, Peru, and Mexico. That represents U.S. bank exposure of about $34 billion. If, we gave about 3 percent interest—3 percentage point interest rate relief to those four countries, that would cost the commercial banks about $1 billion, which would be about 1 percent of bank capital. Something that is much less than has already been written down in their stock market values.

Thank you very much.

[The written prepared statement of Professor Sachs follows:]

May 13, 1986

Testimony to the Subcommittee on International Trade
Senate Finance Committee

Professor Jeffrey D. Sachs
Department of Economics
Harvard University

I. Introduction

The Baker Plan was unveiled in Seoul, South Korea in October 1985 in recognition of the shortcomings of the current approach to the developing country debt crisis. Contrary to the optimistic predictions of many observers after 1982, economic growth and creditworthiness have not been restored in most of the debtor nations in Latin America and Africa. The trade balances of many of the debtor countries have swung sharply into surplus, but not as a result of successful export promotion. Rather, these countries have contracted their imports in response to the cutback in commercial bank lending after 1982. This import austerity has meant a large loss of markets for U.S. exporters. The loss of markets is particularly dramatic with respect to the debtor countries in Latin America, as shown by the following data:

$Billions	1981	1982	1983	1984	1985
Exports of Latin America	108.2	97.6	97.6	103.9	93.3[a]
Imports of Latin America	119.3	96.5	75.9	75.1	50.2[a]
Trade Balance	-11.1	1.1	21.7	28.8	43.1[a]
U.S. Exports to Latin America	42.1	33.6	25.7	29.7	31.0
U.S. Imports from Latin America	40.8	39.6	43.6	50.1	49.1
U.S. Trade Balance with Latin America	1.3	-6.0	-17.9	-20.4	-18.1

[a] First half of 1985, at annual rate.

The large trade surpluses in Latin America are not an indication that the current debt strategy is working, or that it is sustainable in the future. Historians will remember that Germany succeeded in generating trade surpluses in 1929 to pay for its World War I reparations just on the eve of the collapse of the German economy. The trade surpluses signalled depression rather than recovery in Germany.[1] Instead of examining the trade surpluses, it is important to assess the internal economic situation in the debtor countries, which in most cases remains very bad, and in some cases is sharply deteriorating.

The central argument that I shall offer is that the degree of austerity now facing several debtor countries is excessive, and that the austerity can be best eased through a more generous treatment of debt servicing requirements, in the form of debt relief in addition to debt rescheduling (my focus will be on the Latin American debtor countries, though the main themes apply in Africa as well). By attempting to secure full servicing of interest on the Latin American debt, the current strategy is: threatening democracies throughout the region; imposing an undo burden of adjustment on the debtor countries; hurting U.S. exporters by excessively squeezing import demands from the region; provoking high inflation and capital flight throughout Latin America; and, ironically, reducing the long-run value of the creditors' claims on the debtor countries, by discouraging adequate structural adjustments in the debtor economies.

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[1] See H. G. Moulton and L. Pasvolsky, War Debts and World Prosperity, Brookings Institution, 1932, especially pp. 306-307.

Peru is an example of a country in need of debt relief. The economy is in a state of collapse due to the combined pressures of falling export prices, fifteen years of poor economic management, and the heavy weight of debt servicing. Per capita GNP has declined by 15 percent since 1980, and real wages have fallen by an incredible 40 percent. The social fabric is crumbling. Murder, kidnapping, and terrorism are the daily fare of Lima. Drug trafficking provides one of the few profitable activities in a collapsing economy. However, when President Alan Garcia Perez told the United Nations last year that his country faced the choice of debt or democracy, and that therefore he would unilaterally restrict debt servicing payments, his cri de coeur was received as an affront to the banks, and the international financial community has united in opposition to his plea for debt relief.

The situation is little better in many of the other debtor countries. Neighboring Bolivia reached 50,000 percent inflation last year, while Argentina topped 1000 percent and Brazil recently raced to an almost 500 percent annual rate. These three countries now have "shock" anti-inflation programs underway, but the political and economic environment is precarious, and the success of the stabilization efforts remains very much in doubt. Mexico is now reeling under the weight of collapsing oil prices (not to mention years of remarkably large budget deficits) and its inflation could easily race ahead of 100 percent this year.

The current strategy of the G-7 countries for managing the debt crisis, including the new directions of the Baker Plan, has much in its favor, but has at least one deep and unresolved flaw. The strategy properly seeks to treat the debt crisis on a case-by-case basis, since the situation of the various debtor countries differs greatly. The strategy properly calls for policy adjustments by the debtor countries, since without exception, the crisis throughout Latin America reflects serious economic mismanagement by governments in the region, particularly in running irresponsibly large budget deficits for over a decade that left the countries deeply in debt.

Where the strategy goes wrong is in its refusal to contemplate partial and selective debt forgiveness by private and official creditors in cases where the debtor country is crumbling under the weight of the foreign debt burden, or where debt forgiveness might provide an important spur towards positive adjustment. It would be fatuous to destroy fragile democracies in order to collect the last cent on interest due to the commercial banks, particularly when much of the debt in Latin America is already written down in the books of the U.S. commercial banks, and in their stock market values, though almost none has been forgiven by the banks in their negotiations with the debtor country governments.

My own research has indicated that the market value of claims on the Latin American debtor countries is already much below par value, and that the stock market valuation of the major commercial banks reflects that market discount.[2] Both direct and indirect evidence suggests that the marketplace puts a value of about 70-75 cents on the dollar on commercial bank claims on Brazil and Argentina; slightly less on Mexican debt; approximately 35 cents on claims on Peru; and as little as 10 cents on the dollar on Bolivian debt. The irony of this situation is that the U.S. commercial banks could now forgive some of their claims on the Latin American countries without further reducing their market values, which already reflect the anticipation of debt writeoffs.

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[2] See The Economist, 11/16/85, p. 96, for estimates of the market value of debt on the secondary market. With a co-author, Steven Kyle, I have demonstrated that as early as mid-1983, the commercial bank stocks were discounted by about 20 cents per dollar of exposure in Argentina, Brazil, and Mexico. See "Developing Country Debt and the Market Value of Large Commercial

The current strategy for managing the debt crisis does not, of course, intend to destroy democracies in the quest for debt servicing, but it does presume that a "tight leash" approach is the best way to achieve favorable long-term adjustments in the debtor countries. Even this argument is doubtful. The whole point of the Chapter 11 provisions for corporate reorganization in the Bankruptcy Code, is that debt-riddled companies in need of reorganization sometimes require protection from their creditors, and that such protection is often in the interests of the creditors themselves. Without protection, creditors will needlessly and often recklessly decapitalize a faltering firm, to the ultimate detriment of the creditors themselves. By giving debt relief in a Chapter 11 proceeding, the creditors give the corporation the time and resources necessary to reorganize and to resume profitable growth.

Such bankruptcy court protection is not available for the debtor countries, so that for many of them, the inevitable scramble of creditors to remove their assets is underway. That scramble shows up in two ways: banks are doing their best to reduce their exposure, and residents of the debtor countries are fleeing with their own capital. Consider these developments in the major Latin American debtor countries:

Banks," NBER Working Paper Series, No. 1470, September 1984.

	Change in U.S. Bank Exposure, $billion	Capital Flight, 1983-1985, $billion (minus = capital flight)
Argentina	0.1	1
Brazil	-0.3	-3
Mexico	-1.7	-17
Venezuela	-3.9	-6
10 Latin American debtor Countries	-7.5	-30

Sources: U.S. bank exposure from Statistical Release of the Financial Institutions Examination Council, 10/15/84 and 4/15/86; Capital flight estimates from Morgan Guaranty World Financial Markets, March 1986. The 10 countries are: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, Venezuela.

Not only have the commercial banks failed to increase their exposures at annual rates of 6-7 percent as was envisioned by policymakers in 1983, but U.S. banking exposure in the 10 major Latin American countries has actually declined by about 7.6 percent since mid-1984. Latin American residents have behaved no differently from the commercial banks, since the private sector in the large Latin American countries has engaged in capital flight on the order of $30 billion since the beginning of 1983.

The links between the external debt burden and the problem of capital flight should be precisely understood. Throughout Latin America, the external debt is predominantly owed by the governments themselves. In almost every country that has succumbed to the debt crisis, the foreign debt resulted from a decade of thoroughly irresponsible budgtary policies, which led to an incredible fiscal burden that governments are now finding impossible to meet through normal tax revenues. These governments are now paying for the interest on the external debt in part by cutting investment spending and in part by printing money (hence the runaway inflations in Argentina, Bolivia, Brazil, Mexico, Peru, and Uruguay). The inflation and the prospect of future budget deficits contributes to capital flight, by destabilizing the local economy.

Making loans to a debtor government in order to help it to meet its interest payments only partially solves the problem, since the increasing debt of the government signals to the private sector that the fiscal burden is going to be even greater in the future. Debt relief (for example in the form of below-market interest charges on the debt) could, on the other hand, significantly ease the current debt burden and improve private sector expectations at the same time. For obvious reasons, though, debt relief should be predicated on commitments by the debtor government to take other steps to restore fiscal discipline in the long run.

Partial debt relief would be much more effective than debt rescheduling in eliciting needed structural adjustments from the most heavily indebted countries. Consider the differing incentives for adjustment that arise from a dollar of debt relief versus a dollar of debt postponement. In the event of debt postponement, the foreign creditors are the ultimate beneficiaries if the country does well, since the amount of eventual debt repayments will thereby rise. On the other hand, if the debt relief is granted, the country keeps the benefits of its better performance in the future. Thus, debt rescheduling is not so attractive for a politician calling for sacrifice from his fellow citizens. The sacrifice seems to be for the foreign banks, rather than for the country's own future.

By pushing governments to fiscal collapse and even hyperinflation, therefore, the tight leash can become a noose, strangling the confidence of the government and private sector to make structural adjustments and to invest in future growth. As a result of these stresses, net investment in physical capital in Latin America was a remarkably low 5.5 percent of GNP during 1982-1985, less than half of the preceeding decade. The slowdown in investment spending is clearly crippling the growth prospects of the entire region.

It might be argued that some recent developments in the world economy will put the debt crisis behind us. Certainly, the worldwide fall in interest rates and the depreciation of the dollar against the Yen and the European currencies are both highly favorable developments for almost all debtor countries. However, the contribution of these developments to recovery in Latin America should not be overemphasized. The dollar prices of many primary commodities have continued to decline in recent months, offsetting many of the benefits of the lower interest rates. And taken as a whole, Latin America is a large net exporter of oil, the commodity with the sharpest decline in price. Of the ten major debtors in Latin America, Argentina, Bolivia, Ecuador, Mexico, Peru, and Venezuela, are oil exporters.

As I suggest in greater detail below, there could be significant benefits to the U.S. economy from a coordinated program of partial debt relief for some of the most extremely indebted countries, even after netting out the direct costs to the U.S. financial institutions of receiving lower interest payments. The relief would add directly to the financial resources available to the debtor countries to undertake growth-promoting investments, and would directly stimulate the demand for U.S. exports, particularly in our capital goods industries, which have been severely hit by the debt crisis. Moreover, a dollar of debt relief, if tied to good policies by a debtor country government, would promote much more than a dollar of new investment. By reducing the burden on debtor country governments to service their debts, these governments would be better able to balance their budgets, reduce inflation, and restore confidence in the private sector. Well-directed debt relief would contribute to a reversal of capital flight, by helping to restore confidence in the debtor economies. These countries could then draw on the $200 billion or so of private capital flight of the past ten years in order to help finance their future investments. The future development of Latin America would be financed mainly by Latin Americans rather than by U.S. banks, and the U.S. banks could expect a restoration of full interest payments on their remaining claims in the region.

The rest of this testimony is divided into four sections. Section II provides further details on some of the shortcomings in the current debt strategy. Section III outlines some ideas for introducing partial and selective debt relief into the policy mix, and describes a possible administrative arrangement to facilitate partial debt relief. Section IV returns to the fundamental question as to the nature of conditionality that should be imposed in return for debt relief.

II. Further Observations on the Current Debt Strategy

The strategy to date has put the IMF in the front line of the debt crisis. This has been appropriate given that the major internal problem in almost all of the debtor countries has been fiscal irresponsibility, and that the major focus of the IMF is the restoration of reasonable fiscal balance. Nonetheless, the current mode of handling the crisis is breaking down for several reasons:

(1) Democratic governments can no longer be seen to be taking orders from the IMF. Of course the Fund has always maintained that the programs originate with the country in any event, but the public in the debtor countries has generally believed differently. Only recently, with the heterodox Austral Plan in Argentina and Cruzado Plan in Brazil has the IMF been viewed as acceding to the plans of a debtor government, rather than imposing its own plan.

(2) More importantly, the IMF can't offer any substantial financial assistance to most of the Latin American debtor countries in return for those countries accepting IMF conditionality. The IMF judges by how much a debtor government should reduce its budget deficit according to the amount of new external financing that is available to the government. If little foreign money is available, then the IMF demands a very tight adjustment effort as part of its conditionality. In the last two years, private bank lending to the Latin American countries has dried up, and IMF programs have gotten commensurately less attractive. In these circumstances, it doesn't really

cost a government that much to boot the IMF out of the country, which is now happening with ever greater frequency.

(3) Whatever the merits of Fund programs, they are not adhered to with any regularity. Only when a government is disposed to use a Fund program as a way to bolster its own policies in the face of internal opposition do the Fund's conditions have a good chance of fulfillment. On the other hand, when a country is led kicking and screaming into an agreement, the chances for compliance have turned out to be slight. Thus, in recent years the Fund has found a greatly diminshed rate of compliance with its performance criteria, and this drop in compliance has led to a further tightening of Fund programs (more preconditions, a shorter leash on debtors). A recent study of mine gives further details of declining compliance.[3]

(4) The current arrangements give the United States government insufficient flexibility for helping those governments that are key to U.S. foreign policy interests. The success of the Alfonsin government is key to many U.S. objectives in the region, and yet the international and U.S. responses to the ambitious Austral plan have been meagre. The creditor governments might logically have tried to organize a postponement of interest repayments, or to make cuts in interest rates, to bolster the plan in a strong way. Instead, the Fund has insisted on deep austerity, and continued servicing of interest at market rates. The U.S. government, for its part, has

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[3] See "Conditionality and the Debt Crisis: Some Thoughts for the World Bank," Harvard University, 1986.

lectured the Argentine government about the need for supply-side policies (privatisation, liberalization, etc.) that are politically difficult for President Alfonsin to carry out until the stabilization part of the Austral Plan is firmly successful.

A basic strategy of the Baker plan, it appears, is to substitute the World Bank for the IMF in managing the crisis over the next few years, and to emphasize microeconomic "supply-side" considerations, over the austerity of the IMF programs. If this basic outlook is correct, the Baker plan is subject to several serious shortcomings:

(1) Budget reductions remain the top adjustment priority in most of the countries in Latin America. In the absence of some form of debt relief, or in the absence of much greater amounts of foreign finance, budget austerity will be necessary as a matter of simple budgetary accounting. There is no real luxury of choosing between IMF austerity and World Bank growth-oriented policies, unless the budget constraints on the debtor countries are somehow eased.

(2) The amount of short-term debt relief mentioned in Secretary Baker's initiative ($20 billion from the commercial banks and $9 billion from the multilateral agencies over three years) is surely too low, whether that money is managed primarily under the auspices of the IMF or World Bank, or some other multilateral entity. Moreover, by urging the commercial banks to continue lending, the U.S. government makes itself vulnerable to future demands by the banks that the government indemnify them in the event that the new loans go bad.

(3) The degree of intrusiveness of the IMF will pale in comparison with the degree of World Bank intrusiveness, since the World Bank is set up to

monitor the fine structure of microeconomic management in the recipient country. World Bank Structural Adjustment Loans dictate terms with respect to dozens or even hundreds of sectoral policies, that cut to the heart of the political fabric of a country. The outcry over World Bank terms will be even more severe than over IMF terms, if nothing else is done to sweeten the deals with the debtor countries. This is illustrated by the recent "World Bank riots" which erupted in Panama in the past couple of months, over the imposition of labor market liberalization as a condition of a World Bank loan.

(4) The "supply-side" policies stressed in the Baker initiative (privatisation, foreign direct investment, and trade liberalization) would be useful in most of the Latin American countries, but the list of policies ignores several key features of what is "wrong" with the countries in question. In particular, the political elites in many of the debtor countries have run the state as much for private gain as for economic development, with the result that the government sector is nearly bankrupt in several countries. Mexico, Venezuela, Argentina, Peru, and Bolivia, have all been characterised by widespread corruption in the past ten years; cheap loans to powerful political interests made by the government; extensive capital flight, through which the economic elites have protected themselves, even as wages have been severely squeezed; and in some cases, government takeovers of private sector debt at terms favorable to the private debtors (the same group, by and large, with substantial capital flight abroad).

A successful resolution of the debt crisis, and a return to growth and stability in Latin America, will require at least three new directions for policy. First, for many countries, the terms for debt servicing will have to be eased, especially in the new democracies that we are interested in nurturing. Easing the terms will in practice mean interest relief from the private and official creditors, since in the era of Gramm-Rudman budgetary stringency we cannot rely on major amounts of new money from official creditors, and in any event, we cannot expect major increases in private bank loans. Second, the IMF and the World Bank should become just two institutions among many for managing the crisis. Rather than letting the IMF take all of the responsibility for the design of a stabilization program, the responsibility should be centered in a broader group, set up on a country-by-country basis, to include the IMF, World Bank, the G-7, commercial banks, and other major creditor interests. Similar creditor groups have been set up in the past, with great success, for Indonesia, Turkey, and a few other countries. Third, the content of conditionality and the concerns of the creditors should be extended beyond budget control (_à la_ the IMF), microeconomic efficiency (_à la_ the Baker initiative), to include considerations of equity, and the strengthening ofdemocratic institutions. The politics as well as the economics of Latin America need reform. The elites in many countries have systematically plundered the state finances. Real success cases, such as Korea, Singapore, Hong Kong, and Taiwan, all show far more equal distributions of income and fiscal burden than in Latin America.

The next sections of the testimony take up these three issues in greater detail.

III. The Case for Partial Debt Relief

Most corporate workouts and corporate reorganizations under the bankruptcy code involve writedowns of debt, even in cases where the original shareholders and management retain control over the corporation. An overly indebted corporation needs protection from its creditors, both in the timing and the terms of repayment, in order to have the chance to make the difficult management moves needed to get the company back to a profitable condition. Existing debts are written down and often subordinated to new credits during the adjustment period. The presumption is that the ultimate value of the creditor's claims will be enhanced by a policy of stretchouts, partial writedowns, and even subordination of debts to new creditors.

The current strategy for the developing countries, on the other hand, operates on the premise that all debt must be serviced at market rates, that interest payments must remain timely, and that any missed payments of principal should be capitalized at market interest rates for later servicing. Such a rigorous condition for repayment has rarely worked in the past once a country has fallen into severe debt-servicing problems.

The experience in the 1930's and 1940's is instructive. After the collapse of commodities prices in the early 1930s, most of the Latin American debtor countries suspended debt servicing on foreign bonds that they had floated in the U.S. and the U.K. during the 1920's. The debt-servicing moratorium was unilateral, with little negotiation between creditors and debtors until after World War II. In the late 1940's, the debtor countries came up with revised debt servicing plans so that they could qualify for the loans of the newly created World Bank, which was requiring from each country an agreement between the government and its creditors as a precondition for World Bank disbursements.

The terms of agreement were generally very favorable. The unpaid interest during the period of default was generally summed without capitalization, and added to the total stock of principal due. Thus, a $100 coupon due in 1932, and unpaid for the next fifteen years, was charged to the country at $100, rather than at $100 compounded at market interest rates for fifteen years. The resulting "total debt due" (principal plus interest) was then refinanced through a new bond issue, usually at maturities of 30 to 50 years, at very low interest rates. Bonds that originally floated for 7 percent were refinanced at rates of 2 to 3 percent. Those bonds from the late 1940s are now coming due in many cases.

In reality, the debt burden was reduced far below even this small amount. One reason is that the debtor countries secretely entered the bond market in a big way in the late 1930s and early 1940s, in order to buy back their debt at prices of 10 to 15 cents on the dollar. Thus, as an example, of a $42.5 million issue of Republic of Chile Bonds (dated 1926 at 6%, due 1960), the principal outstanding in 1946 was only $20.8 million, the rest having been bought back by the Chilean government during 1935-45. A second crucial reason for the reduction of the debt burden was the substantial rise in commodities prices during World War II, that reduced the debt burden by as much as 50 percent in real terms.

Note that the predominance of bond debt after World War II, rather than bank debt, provided a safety valve that does not now exist. Because of the extensive second-hand market in bonds, the debtor governments were able surruptitiously to buy back their own obligations. Of course the low market quotations proved that the countries were not creditworthy, so that the countries could not borrow again until the debt situation was resolved, but at least they could steadily reduce the outstanding burden without enormous public fanfare.

The current situation holds no obvious safety valve. The second-hand market is thin, and much worse, if a bank sells its claims on a debtor country at below par, it exposes the bank to the demands of its accountants that it write down all of its claims against the debtor country, and not just the amount that it sells on the market. The implications of this accounting rule are that: (1) most transactions in the secondary market for bank loans are swaps, rather than outright sales; and (2) banks rarely sell their paper on the second-hand market until they have been forced by the bank supervisors to make across-the-board writedowns in their books against the country in question. Such writedowns have so far been required only in the cases of Bolivia, Peru, Nicaragua, Poland, Zaire, and the Sudan.

Moreover, up to this date, all interest and principal arrears to the commercial banks have been capitalized at market interest rates (plus penalties!), so that the passage of time in no way eases the debt burden. Also, unlike the experience in the 1930s and 1940s, commodity prices (except coffee) for the major debtors at least until now continue to fall, so that the real debt burden continues to rise.

If debt relief is to be granted, it should be guided by several considerations. First, relief is not a gift; it is a hardnosed judgment that the ultimate value of claims against the country will be raised by reducing the pressures for complete debt repayment. Therefore debt relief should come with strong sanctions against additional uncontrolled borrowing by the country. One mechanism for such sanctions could be as follows. Relief would be given in the form of interest payments below market rates. At any point, the debtor country government could choose to revert to full interest servicing at market rates. During the phase of below-market interest payments, the country's loans would be placed on non-performing status, so that U.S. banks would be restricted from making new loans. The country would then have an incentive to work its way back to full creditworthiness. By combining partial debt relief with sanctions against additional market borrowing, it would be possible to limit the effect of "contagion", in which a large number of debtor countries line up for relief after any one country is granted relief.

Second, relief should be distributed equitably across all creditors, rather than restricted just to the private banks or to the official creditors. Nobody can be seen to be bailing out anybody else. The specifics of debt relief would have to depend on the legal and regulatory status of the various creditors (which will vary by country of creditor, whether the creditor is in the public versus private sector, etc.) To best implement some partial relief, for example, it might be best for some creditors to reduce interest payments; for others to forgive principal; and for others still to make grants of new money. In order to get equitable and adequate across-the-board relief, new mechanisms for negotiation will have to be created, as is described below.

Third, the bank regulators should tailor the accounting rules to permit an orderly and lenient treatment of any debt relief. For instance, cuts in interest rates for a given year should affect the bank's current income only, but not the book value of all of the bank claims held against the country. Moreover, any writedowns of principal should be amortized over several years rather than immediately. This kind of lenient treatment will facilitate writeoffs and will also reduce the chance of financial instability resulting from a loss of bank income.

IV. A New Forum for Negotiations: Consultative Groups

A major problem with the current arrangements for managing the debt crisis is the lack of adequate safety valves (e.g. the chance for countries to buy back their debt at discount) and the absence of an adequate creditor forum to discuss debt relief. The current system puts an undo amount of stress on the IMF. The official creditors and the banks wait for the IMF to work out an agreement with the country, and the the IMF proceeds with a presumption about the amount of foreign finance available. It has no power to broker a debt relief scheme among the major creditors. It has no systematic ability to allow for easier terms in politically sensitive cases. Rather, it must work with the amount of external finance that it believes is available from the rest of the world, add in its own modest amount, and base a program on this "exogenous" bottom line. The result can easily be a breakdown of negotiation.

Any debt relief must involve a complicated deal among the creditors. The problem is the absence of a forum for such an arrangement. A partial but instructive model for the appropriate forum would be the Indonesian bailout of

1970. It will be remembered that Sukarno had left the Indonesian government on the verge of bankruptcy and hyperinflation (inflation reached over 1000% percent in 1966). After a civil war, a new military regime under Suharto began to bring order to the country. The Suharto regime first received debt relief from official creditors (in those simpler days, the commercial banks were hardly involved!) as of late 1966, when three years of grace on all principal and interest payments were granted. Moreover, the interest was not to be compounded, so that the postponement reflected substantial relief in present value terms. In 1970, this arrangement was put on a more permanent basis. A standing committee of creditor governments, known as the Intergovernmental Group on Indonesia (IGGI) was constituted, and this creditor group negotiated new terms with the Indonesian government. Since that time, the IGGI has overseen Indonesian macroeconomic developments on a year to year basis.

The specific nature of the Indonesian debt relief was as follows. The debt was consolidated, with principle to be repaid in thirty equal annual installments, and interest (at 3%, much below market levels) to be repaid in fifteen installments, to begin as late as 1985 and to run through the year 2000. The arrangements even included the provision that Indonesia could postpone up to three annual payments in the event of a shortfall in export earnings. The package, in all, represented substantial debt relief in present value terms.

The arrangements were made with the intergovernmental group, in which a key aspect was that the general arrangements had to be further negotiated in detail by Indonesia with each of the country creditors. In other words, the arrangement provided a general framework within which Indonesia could negotiate with its creditors on a country-by-country basis, in which the detailed settlements could respect the differences in regulations, accounting, etc. among the creditor nations. That kind of flexibility will be crucial in any debt relief extended by a large number of official and private creditors from several different countries.

The Indonesia operation was enormously successful. The hyperinflation ended by the late 1960s, and since that time (with the exception of the debt problems of Pertamina in 1975) the Indonesian macroeconomic performance has been among the best in the developing world. From a situation of near hyperinflation and civil strife the economy has grown at over 5 percent per year for a decade, with low inflation. And with the constant tutelage of aid agencies and development specialists the quality of macroeconomic management has been dramatically improved.

That kind of debt relief could be extended to several of the most seriously indebted countries. The general framework should be an ad hoc workout committee for each major debtor country, which includes all of the major creditors, both official and private. The IMF and World Bank should be key members of the committee, but should be there to provide funds and expert advice and judgement on a proposed program, rather than to set terms with the country. A typical workout committee should have about fifteen members, including representation of the IMF, World Bank, the relevant regional development bank, representatives from the G-7, the commercial banks, and other creditors (suppliers, bondholders). The committee should aim to reach an agreement in principle with the debtor nation, which can then be negotiated on a creditor-by-creditor basis by the debtor country.

Such an arrangement would have several advantages over the current set-up. The IMF would not be set up to speak for the banks or for the official creditors: the various creditors would be represented at the same negotiations along with the Fund. The IMF would be there to provide expert advice as to whether a proposed plan shows basic macroeconomic feasibility. By having all of the creditors together, it would be possible to share the burden of debt relief. It is not possible now, for example, for the IMF to bargain with the country a program in return for bank interest relief, since now the IMF has no authority over commercial bank interest rates.

It would be most important that the debtor country approach the creditor committee with its own plan, rather than having the plan dictated or designed from the outside. The debtor government should undertake the domestic political fights to make a program, and then approach the committee, rather than appearing to bend over to external pressures. This is the approach recently chosen by Alfonsin, Garcia, Paz, and Sarney, and it has greatly enhanced the political appeal of their recent stabilization efforts. Such an approach also provides far more guarantees to the creditors that the plan will actually be carried out, since the government becomes instrumental in devising its own stabilization policies.

The country's plan should be evaluated by the IMF, which would provide a technical memorandum in support or opposition to the proposal. However, the IMF's judgement would now just be one voice among many in any final decision to go ahead with a plan. The IMF could certainly decide not to go ahead with its own loan on the basis of an unfavorable review of a program, but it could no longer effectively veto a relief package or rescheduling agreement agreeable to the other creditors.

Agreements between the debtor government and the external creditors will by nature have to be reached by the unanimous agreement of the various major classes of creditors, since there is no supranational power that can force an agreement among the different creditors. However the commonality of interests among the creditors in restoring growth and debt-servicing potential in the debtor country should mean that such an agreement will generally be within reach. Moreover, as already stressed, the agreement should be stated in general terms, so that the terms can be made to conform with the regulatory environment in individual countries. Note that while creditor governments cannot necessarily dictate that the private bank creditors offer debt relief, they have administrative means to press banks into complying with a relief package (e.g. by varying the classification that supervisory agencies attach to the problem loans of a debtor country).

IV. The Contents of Conditionality

There remains the question of what policies a country should stress in order to qualify for a relief package. The current emphasis in the Baker Plan is on conditions for microeconomic efficiency: liberalization of trade, privatisation of state enterprise, and opening to foreign direct investment. Recent research (by Bela Balassa, myself, and many others) tends to confirm that liberalization should certainly be part of a long-term adjustment program.[4] However, the strong focus on this policy dimensions is problematic in some ways.

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[4] See, for example, my paper "External Debt and Macroeconomic Performance in Latin America and East Asia," Brookings Papers on Economic Activity, 1985:2.

First, the long history of macroeconomic policymaking and debt crises suggests that macroeconomic imbalances should be treated prior to extensive supply-side surgery. The double-barrel approach of doing everything at once was tried in the Southern Cone countries (Argentina, Chile, and Uruguay) in the 1970s, with disasterous effect. Most observers now see that the macroeconomic goals of price stability and balanced budgets conflicted with the liberalization goals of undervalued exchange rates and tariff reductions. The result was general policy inconsistency, with neither the macroeconomic or microeconomic targets being well served. The success stories of Korea, Taiwan, and Indonesia, all show the pattern of a return to low inflation for a few years before a major assault on trade restrictions.

Even then, liberalization must proceed slowly. The simple and sad truth is that liberalization rarely succeeds, and that successful liberalization takes a long time. Extensive liberalization simply cuts across too many powerful political interests, whose power usually helps to explain the reason for the restrictions in the first place. In a celebrated study by Krueger and Bhagwati of 23 liberalization attempts during the 1950s, 1960s, and early 1970s, only 4 actually succeeded in the "long term" (up to the point of publication of the study). And in all of those four cases, the initial conditions at the time of liberalization were vastly superior to the conditions now facing Argentina, Brazil, Mexico, or most of the other Latin American countries. And when liberalization does succeed, it usually does so slowly.

One of the most celebrated liberalizations in the past thirty years is that of South Korea started in 1964. And yet after 21 years of liberalization policies, nobody would actually call South Korea a case of open trade. Rather it is a case of a unified exchange rate that is not systematically overvalued; a declining number of quantitative restrictions; and a relatively uniform and rational tariff structure. But laissez faire it is not!

Perhaps the most troubling part of the current emphasis on supply side measures is its exclusive emphasis on efficiency, without looking at all to the question of equity and fairness in the Latin American societies. I think that it is fair to say that healthy societies (not otherwise ravaged by war) do not reach hyperinflations or high inflations of the sort seen in Argentina, Brazil, Bolivia, Peru, Chile, Mexico, Uruguay, and other countries in the hemisphere. In each of these cases, there is something grossly wrong with the legitimacy of the government, its ability to tax its citizens appropriately or to reduce spending to influential groups, and its ability to call on the private sector for the kinds of sacrifices needed for economic stabilization. It should be stressed that the Asian countries in general suffered the same shocks as did the Latin Americans in the 1970s, but continued to grow through them with low inflation and economic stability.

The elites in the Latin American societies have done rather well in recent years, while the urban poor and working classes have suffered markedly. The rich took their money out in the form of capital flight. Crude estimates by Morgan Guaranty put cumulative capital flight during 1976-1985 at $53 billion in Mexico, $26 billion in Argentina, $30 billion in Venezuela, and $10 billion in Brazil. Available data show approximately $30 billion of capital flight during 1983-85 alone, after the onset of crisis in 1982. With a large cache of dollars outside of the country, many rich families can live even better now than before 1982, because of the sharp fall in dollar prices in the Latin American economies (following the collapse of overvalued exchange rates with the onset of the debt crisis).

Without due care, the social inequities can be exacerbated both by standard IMF programs and by the emphasis on liberalization and privatisation. The IMF package typically squeezes the urban middle and lower classes, to the benefit of the rural sector and the urban elites (who hold large amounts of wealth abroad). Rather than raising taxes on the rich, who haven't paid much in years, recent adjustment efforts have more often focussed on budget cuts and real wage reductions in the public sector. It isn't that such policies are wrong from a narrow macroeconomic viewpoint, but they may be unfair. The same problems arise in the context of liberalization. Such policies are correct microeconomically, but they can exacerbate income inequalities and inequities.

The creditor governments, and especially the United States, should urge the Latin American governments to come up with fair and equitable burden sharing within their countries as part of the conditionality package. A central goal of the U.S. government is to build durable and prosperous democracies in the region. These goals will be best served if conditionality focuses on issues of equity as well as economic efficiency.

Senator DANFORTH. Professor, thank you. Under the early bird rule, I arrived first and then Senator Baucus, then Senator Mitchell, Senator Grassley, Senator Chafee, Senator Bentsen, and Senator Long.

Professor Sachs, basically, what we and the world have been telling Mexico and other countries is tighten your belts, pay your interest at all costs and do so by importing less and exporting more. Is that a fair generalization?

Professor SACHS. Yes; that is a fair assessment.

Senator DANFORTH. And, it would follow that our reason for taking that position would be that the banks have to be paid off at all costs and that the manufacturing sector of our country would be the one to bear the brunt of the new trade policies of the lesser developed countries. Those countries would be importing less of what we produce and exporting more of what we produce.

Professor SACHS. I think that is right. I believe that as a general principle of course, we should try to get this service, where possible. My argument is that there is a breaking point and that, when it becomes evident it should be recognized.

Senator DANFORTH. And, when we tell another country to tighten its belt, sometimes that belt can be tightened to the point of causing internal upheaval, real difficulties within the country.

Professor SACHS. In my testimony, I say a tightened belt can become a noose. Which may be a bad metaphor, but I think it is strangling a number of these economies by turning so tight in fact, what is happening is that inflation is erupting. As inflation is erupting, capital flight from these countries is increasing as well. So, not only are we not putting new capital in, we are pushing it out by this extremely tight policy. Which is not even in the interest of the creditor banks themselves.

Senator DANFORTH. Yesterday, we had a hearing on the authorization for the Customs Service and Senator Long, particularly, expressed concern about the drug traffic from Latin America. You mentioned it yourself, that is—turns out to be the growth industry in Latin America. Is there a relationship, do you think?

Professor SACHS. There is most certainly both direct and indirect channels of many sorts. But, fundamentally, when the rest of the economy is collapsing in these countries, the drug business is the only one that can continue to prosper.

Senator DANFORTH. Now, what are the downsides, if any, to debt relief.

Professor SACHS. Well, the downside clearly is that it becomes contagious and too costly. There is no question, that if there was a great contagion of countries lining up for significant relief, it could hurt the financial system. I believe that could be limited in certain ways. I think that the relief should come along with sanctions.

The debt relief is not a free ride, once relief is granted, assets to that country should be declared nonperforming and U.S banks should not be encouraged to make new loans. It is just that instead of making new—extending new loans to these countries, that money should come in the form of debt relief.

By attaching sanctions to the debt relief, I think it will be possible to stop the contagion. I very much doubt that a country, such as Korea, would line up for debt relief, if it meant no further loans from the international community.

Senator DANFORTH. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Dr. Sachs, have you seen the Joint Economic Committee report?

Professor SACHS. No, I have just heard the press, the press coverage.

Senator BAUCUS. Based upon what you know of it, and the press reports you have seen, I would like to know the degree to which you agree with it.

Professor SACHS. Well, I try not to agree with things I have not seen, yet. But, from your summary of it, I think that the emphasis is certainly in the right direction. That it focuses on the strategy of being pay interest at all costs. And, that is perhaps in myopic strategy, given the developments we see in Latin American economies.

Senator BAUCUS. According to your analysis, do you have any sense of the degree to which U.S. debt policy for Latin American countries has hurt the U.S. agricultural industry or U.S commodities, which depend very much upon exports for their livelihood?

Professor SACHS. Well, one can see in the statistics of the sort, that have been summarized here and are described in my testimony and have a very, very sharp decline in exports to Latin America.

Studies have shown that that decline was not due to the dollar, but to the collapse of the Latin American economy. So, there is a separate affect above and beyond the dollar, that has come from the austerity in the Latin American countries.

It should be clear, however, that I think the austerity is not completely unjustified. The countries in Latin America ran completely irresponsible budgetary polices for over a decade. The problem is not that we have done something to them to force this austerity. The austerity is a reflection of previous irresponsible fiscal policies in those countries. The problem is simply that we have come to a breaking point in the number of countries.

Senator BAUCUS. Is it your understanding that the United States, IMF or World Bank and commercial banks encouraged these Latin American countries to service their debt by dramatically increasing their exports?

Professor SACHS. They certainly have. I think there was an anti-export bias in those countries to begin with, so, I do not—I actually think that there is wisdom to the notion, that the Latin American countries should extend their exports. But, that can be done in a growing context without pushing them to the brink of collapse.

Senator BAUCUS. I am wondering, too, how familiar you are with statistics which show that banks' profits have actually increased during this period. That is, the dividends of the nine major money centers and profits have increased. Some of that is reflected through the larger spreads that the banks have charged or earned on Latin American loans.

Professor SACHS. That is certainly correct, although, I think the interesting thing to point out is that studies of the market value of the banks, that is the stock market quotations, show that investors have written down a lot of this debt.

Heavily exposed banks have done more poorly in the stock market than unexposed banks on the international loans. That has a measure of optimism in it, in the sense that it means we could give some debt relief without further depressing the market value of the banks. Because the stock market has to some extent, already anticipated that development.

Senator BAUCUS. So your saying that if the banks themselves were to write down these loans to some degree, that would not be adversely reflected in the stock market, because the market is already written down?

Professor SACHS. That is right and I should make one point. There—perhaps my language has been sloppy. Banks are writing down in their own books, a lot of these loans, but, they are not forgiving them. My argument of course is, these loans should be forgiven or relieved in one way or another. I think the best way to do, that is for several reasons to do it by, having below market interest rates on the debt, rather than writing down principal.

But, nonetheless what happened is that the stock market has anticipated such relief. The books kept by the bank have anticipated such relief, but the countries have not felt any of the benefit of it, yet.

Senator BAUCUS. How do you know the market has already anticipated this relief?

Professor SACHS. Well, there have been several studies including one I did of 60 banks. Examining their stock market performance in the last 3 years and there is a clear correlation between the degree of their exposure in Latin America and the movements of their stock prices. And, so one is able to see statistically, that indeed there has been a writedown in the market already.

Moreover, we have evidence on trades, or swaps and direct sales of some of this debt in the secondhand market, which is quite small for a number of regulatory reasons. That market also shows that this debt is highly discounted. For Argentina, Brazil, and Mexico, perhaps, it is 0.70 on the dollar. For Bolivia, which you remember had the hyperinflation, it is about 0.10 on the dollar. So, the market is already reflecting this, well ahead of any forgiveness. They are anticipating the forgiveness.

Senator BAUCUS. How do you know that, if some of these loans were forgiven, there would not be a further reduction of the market value?

Professor SACHS. Well, one can infer from stock market quotations, that perhaps the stock market is putting the values of these assets at 0.80 on the dollar, say for Brazil. If the writedown were less than the 0.20 writedown and, if that were regarded as a sufficient step then I would not anticipate further declines. If, however, the writedown were more than 0.20 on the dollar and the market regarded it as an indication that there was going to be an even more severe writedown, then of course, there would be a further movement down in the stock market value.

Senator BAUCUS. How would you look upon legislation which would require the banks to reduce the spread or to some degree writedown or forgive some of these loans? That is, so the banks will shoulder the burden, somewhat proportionately with American agriculture and other U.S. commodity industries.

Professor SACHS. I cannot say—I cannot speak to the way that the legislation should provide for this. Because, there are many difficulties, particularly coordinating the efforts of all of the international creditors, not just the U.S banks. I think what my proposal stresses, is the need for a new forum, where the creditors jointly can agree on debt relief. You cannot ask the U.S. banks to do it alone.

What we need is a setting where all the creditors can jointly agree to writedowns. We do not have that kind of institutional framework now. Although, I site in the papers, several historical examples, such as Indonesia in the early seventies, where exactly, that kind of forum was developed. And, that is the direction that I think we have to move.

Senator BAUCUS. Thank you.

Senator DANFORTH. Dr. Sachs, Secretary Baker has now arrived. If you do not mind, we will take him now, because he has something else he is going to have to do in about an hour or so.

Professor SACHS. Thank you very much.

Senator DANFORTH. If, you would let him play through?

Mr. Secretary, thank you.

Mr. Secretary, we very much appreciate your being here on two obviously important aspects of our trade problem. Namely, the exchange rate situation and the problem of Third World debt. You have, particularly since last fall been very deeply involved in these two areas, for which I am sure all of us commend you. We look forward to any comments you have this morning.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY OF THE TREASURY, WASHINGTON, DC

Secretary BAKER. Thank you very much, Mr. Chairman. I am delighted to be here. And I have a statement, that I would ask be included in the record and, if I might, I might read a brief summary of it.

Senator DANFORTH. Fine, thank you.

Secretary BAKER. I am delighted to have the opportunity to discuss the administration's approach in dealing with large U.S. trade deficits, particularly as they reflect problems relating to the exchange rate system and to the debt situation in the developing countries. Before I begin, let me offer my congratulations to the Finance Committee as a whole, for successfully completing work on a major bill on fundamental tax reform.

The administration recognizes and shares congressional concerns about the impact of exchange rate volatility and LDC financial difficulties on the international competitive position of American industry, American agriculture, and American labor. We have been and are actively pursuing a comprehensive strategy to address this problem. I am pleased to be here today to describe our approach and to encourage your support for it.

We are making significant progress in establishing the fundamental conditions necessary to achieve and maintain a sound and growing world economy, more balanced trade positions and greater exchange rate stability.

The Plaza Agreement of last September has resulted in exchange rate relationships that I think better reflect underlying economic conditions.

The Plaza Agreement also contributed toward stronger, more balanced growth among the major industrial countries.

Inflation has been cut sharply and is expected to stay low. This has facilitated a substantial reduction in interest rates and it enhances prospects for further declines.

The deterioration in our trade position will be halted this year and we look forward to substantial improvement next year.

The United States has launched a major initiative to strengthen the international debt strategy.

Preparations are well advanced for launching a new round of multilateral trade negotiations.

However, problems still remain. Unemployment remains high in many countries and large domestic and external imbalances persist.

Uncertainties about the future behavior of exchange rates have also been prevalent. We also have the debt problems of the developing world and we know that protectionist pressures remain strong.

The progress that has been achieved in the general economic environment, however, provides a golden opportunity to resolve these remaining problems. At the Tokyo summit, the President and the heads of the other free world democracies manifested the political will and leadership to confront the tasks that remained.

The Plaza Agreement and subsequent coordinated interest rate reductions evidenced the willingness and ability of the major industrial countries to cooperate more closely on their economic policies. At the same time, experience of the past year demonstrated that exchange rate changes alone could not be relied upon to achieve the full magnitude of adjustments required in external positions.

It has become increasingly more apparent that closer coordination of economic policies will be required to achieve the stronger, more balanced growth and compatible policies necessary to reduce the large trade imbalances that remain and foster greater exchange rate stability. For this purpose, we went to Tokyo seeking to build upon the framework embodied in the Plaza Agreement and to establish an improved process or mechanism for achieving closer coordination of economic policies on an ongoing basis.

Mr. Chairman, I believe we succeeded. The arrangements that were adopted involve a significant strengthening of international economic policy coordination. Details of the new procedures will, of course, have to be worked out in subsequent discussions. However, I see the enhanced surveillance process working as follows:

First, the measures for use in assessing country goals and performance will be agreed upon by the countries participating in the enhanced surveillance process utilizing the broad range of indicators stated in the Tokyo communique. These indicators would include: growth rates, inflation rates, unemployment rates, fiscal deficits, current account and trade balances, interest rates, monetary growth rates, reserves, and exchange rates.

Second, each country will set forth its economic forecasts and objectives in terms of these indicators.

Third, the group would review, with the Managing Director of the IMF, each country's forecast to assess consistency, both internally and among countries.

Fourth, in the event of significant deviations in economic performance from an intended course, the group agrees to use its best efforts to reach understandings on appropriate remedial measures, focusing first and foremost on underlying economic fundamentals. Intervention in the exchange markets could also occur, when to do so would be helpful.

What is new in the arrangements adopted in Tokyo is that the major industrial countries have agreed that their economic forecasts and objectives will be specified taking into account a broad range of indicators, and their internal consistency and external compatibility will be assessed. Moreover, if there are inconsistencies, efforts will be made to achieve necessary adjustments so that the forecasts and objectives of the key currency countries will mesh.

Finally, if economic performance falls short of the intended course, it is explicitly agreed that countries will use their best efforts to reach understandings regarding appropriate corrective action.

In sum, Mr. Chairman, we have agreed on a more systematic approach to international economic policy coordination that incorporates a strengthened commitment to adjust economic policies. I am hopeful that the spirit of cooperation that made this agreement possible will carry over to its implementation. If so, we can look forward to greater exchange rate stability, enhanced prospects for growth, and more sustainable patterns of international trade.

Successful economic policy coordination among the industrial nations complements our efforts to deal with LDC debt problems by strengthening the world economy, creating the conditions for lower interest rates, and helping to improve access to markets. As you know, the "Program for Sustained Growth" for the major debtor nations proposed by the United States in Seoul was premised on credible, growth-oriented economic reform by the debtor nations, supported by increased external financing.

In Tokyo, the summit leaders welcomed the progress made in developing the cooperative debt strategy, in particular building on the United States initiative. The United States Program for Sustained Growth has also received strong support from the international financial institutions, national banking groups in all major creditor countries, as well as the key IMF and World Bank Committees representing both debtor and creditor countries and the OECD ministerial.

Required policy changes in the debtor nations will take time to put in place and they should not be expected to occur overnight. The process of implementing these reforms will also be much less public than the series of announcements to date supporting the debt initiative. Implementation will take place through individual debtors' negotiations with the IMF, the World Bank, and the commercial banks. This process is already underway. The IMF, for example, has existing or pending arrangements with 11 of the 15 major debtor nations. The World Bank has structural or sectoral loan negotiations currently underway with 13 of these nations and has recently extended loans to Ecuador, Argentina, and Colombia to support adjustment efforts in some of their key sectors.

As the summit communique noted, sound adjustment programs will need to be supported by resumed commercial bank lending, flexibility in rescheduling debt, and appropriate access to export credits.

The Program for Sustained Growth is important because it touches on a wide range of U.S. interests, but paramount among these is its importance for U.S. trade.

Our exports to the major debtor nations, which have already increased by 18 percent, or $4 billion during the past 2 years, can be expected to improve further in response to both recent exchange rate changes and stronger growth in the debtor countries, as they adopt economic reforms.

It will also be important, however, for the United States and other industrial nations to maintain open markets for LDC exports. Open markets are essential to our overall international strategy for economic adjustment and policy coordination.

The administration is committed to maintaining an open U.S. market and ensuring a free, but fair, international trading system. President Reagan and the others at the Tokyo economic summit pledged to work at the September GATT ministerial meeting in Geneva to make decisive progress in launching the new round. We are also starting negotiations to remove barriers to trade and investment between the United States and Canada.

We are pursuing an aggressive program against unfair trade practices. President Reagan is the first President to self-initiate action under his retaliatory authority against such practices, including cases involving Japan, Brazil, Korea, and Taiwan. The President has also announced that, unless we are able to resolve our dispute with the EC over its new restrictions affecting our farm exports to Spain and Portugal, we will respond in kind.

Our aggressive policy against unfair trading practices has already met with considerable success. We have settled disputes involving canned fruit, footwear and leather import quotas, liquor, tobacco, and motion pictures.

In sum, I strongly believe our policy of free, but fair, trade is working and is in our overall economic interest.

At this point, Mr. Chairman, I would like to address the question of proposed international finance and trade legislation, such as S. 1860. I can well understand your frustration over our trade deficit. However, certain modifications in our trade law will not eliminate the trade deficit and may actually make it worse.

The answer to our trading problems is a comprehensive, international economic policy strategy that addresses international trade, monetary and debt issues in a coordinated fashion and involves the cooperation of other nations. We have developed such a strategy, as I have discussed here today, and we are implementing it.

We are, of course, prepared to engage in thorough and meaningful discussion with this subcommittee on all pending legislation.

We must avoid passage of protectionist trade legislation that would alienate our trading partners, encourage them to enact similar protectionist policies, and undermine the administration's international economic policies. Closed markets and an atmosphere of confrontation would doom our efforts to solve our international economic problems in a responsible and constructive manner. The greatest threat today to economic well-being worldwide, I think, is the danger of protectionism and a subsequent trade war.

We need your help to avoid these dangers. I urge you to give the administration policies a chance to work.

Thank you, Mr. Chairman.

Senator **Danforth**. Mr. Secretary, thank you. And I want to assure you that at least speaking for this Senator, I fully intend to withstand pressures for protectionism. I think my definition of protectionism and the administration's may be a little different. I think the administration tends to define anything that walks as protectionism.

But, I think that the thrust of your comment is well taken. And also, I might say, I know that you and others in the administration must view me and other members of this committee as being constant pains in the neck with respect to international trade. But, I want you to know that I welcome the initiatives that the administration has taken, particularly since last September, with respect to the initiation of section 301 cases against unfair trade practices, and also the administration's initiative begun by you last fall and furthered in the recent economic summit with respect to a more activist position on the exchange rate problem.

I take it, that with respect to the value of the dollar, the days of the laissez faire approach are over and that the administration is committed in cooperation with other countries to a more activist role to make sure that the dollar does not again get out of sight.

Secretary **Baker**. Mr. Chairman, we believe, as we have said before, that there is room to improve the current system. There is room, we think, to provide more stability for exchange rates; to remove some of the volatility of the current floating rate exchange system. That is one of the objectives we are seeking by the agreement—which we were fortunate to obtain at the Tokyo summit—calling for enhanced surveillance.

Senator **Danforth**. Do you think, if your own view is our Government's view, that the value of the dollar against the yen is now about right or is the dollar too high or too low? And, were any representations made to the Japanese at the summit with respect to the relative value of the dollar and yen?

Secretary **Baker**. Mr. Chairman, for some time we have been saying, that we do not have a target for the dollar, and we do not. At the same time we are somewhat concerned about what we think are unwarranted interpretations, that the market sometimes attaches to that statement. At Tokyo we discussed the importance of stability in the yen-dollar exchange rate, as well as the importance of continued growth in the Japanese economy, particularly through increasing domestic demand.

Senator **Danforth**. Is the answer——

Secretary **Baker**. You want a yes or no, and that is the answer. [Laughter.]

Senator **Danforth**. Well.

Secretary **Baker**. You may not read anything into that, but I think others probably will.

Senator **Danforth**. Well, fine. There are very perceptive people in the audience.

How about those countries where we have not made progress, especially Canada, Korea, and Taiwan, where the value of the dollar has not been declining against other currencies. For instance, Canada has been the source of increasing trade problems with the United States. Some people think Korea is the next Japan. The values of those currencies remain low compared to our own. What, if anything, are we going to do about those three countries?

Secretary **Baker**. Well, Mr. Chairman, I think the fact that there has been a depreciation of the dollar will mean that other industrial country markets will become relatively more attractive to exporters in the countries that you have just mentioned. So that the decline of the dollar will have a beneficial effect on our trading relationship with those countries, even though they might tie their currencies to ours. It should help to reduce some of the pressure in our market. We would expect to see some reduction in the U.S. share of exports from those countries.

Senator **Danforth**. But, you have no particular program with respect to the value of the dollar, say to the Canadian dollar?

Secretary **Baker**. There is not a lot we can do about those countries that tie their currencies to ours; but, I think the fact there has been a depreciation of the dollar will help our trading relationships with those countries by putting more pressure on their markets and less on ours.

Senator **Danforth**. When would you expect to see the upswing of the J-Curve? The last trade figures that came with Japan showed that we were running the largest trade deficit with Japan in history. When do you expect to see results?

Secretary **Baker**. Mr. Chairman, we expect the trade numbers for 1986 overall to be roughly what they were for 1985, but as I indicated in my statement, we expect to see significant improvement in 1987. I am not an economist, so I will just tell you what I have heard from economists. That is, due to the J-Curve it takes 12 to 18 months before you start seeing the effects of exchange rate changes in trade figures. The dollar reached its high in February 1985. We are now at 13 or 14 months. It is our view that in the fall of this year we should begin to see substantial improvement in our trade numbers.

Senator **Danforth**. Senator Baucus.

Senator **Baucus**. Thank you, Mr. Chairman. Mr. Secretary, I am sure you read about the Joint Economic Committee Report, which essentially questions American loan policy in Latin America. Namely, the reliance upon the large banks, the nine money centers and helping to relieve some of the pressure of those countries by giving substantial loans. Some of those banks charge much higher spreads, and the basis points have risen from 85 in 1981, to an average of 125, a 50-percent increase, in some cases this year. There is a very definite policy which calls on those countries to very vigorously expand their exports of agricultural and other commodities to the United States, and at the same time dramatically decrease their imports of those same commodities from the United States. The net result is that the banks profit. Their dividends have substantially risen at the same time that the profits of agriculture and other commodity producers in the United States have dramatically declined. It is a policy where the people living in those LDC's have not enjoyed a higher standard of living, but, in many cases have suffered increased malnourishment and higher poverty rates. What is your reaction to that basic observation?

Second, I am interested in the degree to which the administration is adopting policies which even out the burden that Americans have to shoulder in trying to help resolve the LDC crisis, so that the burden is not disproportionately on American agriculture and other commodities for the benefit of the large banks.

Secretary **BAKER**. Well, Senator Baucus, as you know in multilateral institutions, we vote against loans for commodities that are in oversupply. I think with respect to the debt problem, it is important to remember that it is important to the United States and to agricultural interests in the United States, that we keep those LDC markets open. Those markets constitute a significant market for our agricultural products.

It is important that those economies prosper to the extent that we can assist them.

Senator **BAUCUS**. The question is whether they can prosper at American expense and the degree to which they have prospered——

Secretary **BAKER**. Let me suggest to you, I really disagree, frankly, with the JEC report. And, I disagree with it primarily on this basis. As I understand the report, it concluded that some of the proceeds of these loans were used for debt service, instead of for some other purpose. And, therefore, there were smaller purchases of U.S. agricultural products. The loans were used for debt service and imports were cut back. I would suggest to you that, had we not followed a prudent debt policy, there would have been less access to those markets by our agriculture, because it is important that those countries continue to have access to capital or they are going to have to cut back on their imports even more.

Senator **BAUCUS**. Dr. Sachs who just preceded you, stated that he felt that goal could be accomplished if the banks were to write down or forgive some of those loans to some degree. This would probably increase access to those countries.

Secretary **BAKER**. Well, I think it would be very counterproductive for governments to somehow try to require or suggest that private financial organizations or the private credit market should make below cost loans.

Some of the major debtor countries—Brazil, Argentina, and Mexico—are obtaining reduced spreads from what they were when those loans were first made. The banks are making loans now or renewing loans at very small margins over Libor. So, that is taking place and I do not have any quarrel with that suggestion. But, to the extent that there is an intimation that somehow the bank should loan at less than their costs, what that will do is cut those countries off from access to credit markets.

Senator **BAUCUS**. The Casey report shows that if the spread were not increased at all during this period there would be a 10-percent reduction I believe in aftertax profits. This would still result in, as I remember the report, $3 billion in profits for those same banks. I do not know what the precise answer is, but I think it is clear that the banks, if not getting a free ride, are getting off pretty well at the expense of other Americans. Ironically, at the expense of smaller banks, including agricultural banks, whose AG portfolios as you know are under severe stress. I strongly encourage the administration to pursue policies which even out the burden, it is not falling disproportionately upon American agriculture.

Secretary BAKER. I think the key, if I might say so, Senator, and I am sure you will not disagree with this, is to see to it that those countries reform their economic policies in a way that would permit them not only to repay their debt, but also to buy more goods from the United States, including agricultural goods.

Senator BAUCUS. My time is up. Thank you.

Senator DANFORTH. Senator Mitchell.

Senator MITCHELL. Thank you very much, Mr. Chairman.

Mr. Secretary, The administration's current policy, which I think can be dated back to the Plaza agreement, represents about a 180 degree reversal over prior policy with respect to intervention in exchange rates. My question is, Can you be more specific about the arrangement reached with our allies in Tokyo to attempt to manage such rates and what assurances do you have that our allies see this agreement the same way you do? For example, what will the Japanese do specifically to deal with the massive surplus involved? And, I wonder if you could be as specific as possible.

And finally, I will ask a series of questions and you can comment in single narrative. What is your impression of the exchange rate provisions contained in this bill? Will they help or hinder your effort in that regard?

Secretary BAKER. Well, let me answer that one, first, if I might. I think that the exchange provisions in this bill, in light of the actions that we have taken at the Plaza and in light of the actions we have taken at Tokyo, are unnecessary.

I do not think they would be helpful because in some degree they limit our discretion and they would mandate certain actions that would be very difficult to ever achieve. So, I do not think they would be helpful.

You ask me how the agreement is to work and whether or not our trading partners will have the same interpretation of it as we do. I think it is significant that they agree to see this set forth in a summit communique. Never before have we had something like this actually spelled out in a communique from the Economic Summit. And this was not something totally precooked before we got there.

So, they are as interested as we are in doing what we can to eliminate volatility in the exchange markets. No one under this agreement, Senator Mitchell, cedes any sovereignty, nor should they. In my view, we would not want to cede any sovereignty with respect to the conduct of our economic affairs and, clearly, most of those countries would not either. This depends on good faith, cooperation, and coordination. That is what it calls for.

But I also think it will bring some peer pressure, perhaps some public pressure, to bear on countries who simply refuse to take action, because under this agreement, they agree to use their best efforts to bring their policies in line, when they deviate from the intended course.

So, I think from that standpoint it will be helpful if some of these countries will want to see it implemented more strictly than others. And, implementation is the key to it; but it is an international agreement, as in the case of other international agreements, we just have to stick with it and keep working on it to get the best implementation that we can.

Senator **Mitchell**. While your comment about the provisions of the bill being unnecessary, it might be appropriate in view of the current administration policy, since the administration has reversed itself 180 degrees once, there is not much assurance that it might not do so again.

I remember you sitting right there and I asked you a question about exchange rates. You said, "Well, there cannot be any such thing as overvalued currency, because, since it is set by the market by definition, the value is what the market sets." You may recall that statement; of course, you would not make it today. So, I think you have to take into account that the legislation is framed against a backdrop of shifting policy and expresses such a concern.

I do not have another question, I just want to make a comment, following up what Senator Danforth said at the outset. It is a little distressing that every congressional initiative is immediately, instantaneously branded as protectionist by the administration, virtually without any regard to it's content. I noted in your statement in the conclusory paragraph on this legislation, you used the phrase protectionist or protectionism in the course of just a few sentences.

Many of us, of course, do not agree with that assessment. I think what has happened, as I said in my opening remarks, is that the administration's attitude tends to polarize policy between free trade, which implies no restrictions of any kind, and protection, which implies no trade of any kind. And the reality of the international trading arena is somewhat more complex than that.

I would hope that the perjurative club of protectionism would not so swiftly be applied to anything suggested by the Congress and that perhaps we could work to try to get some trade reform that will be meaningful and helpful for the country, and I think, frankly, that the overall legislation does move us in the right direction.

Secretary **Baker**. Well, Senator Mitchell, let me just say it was not my intention, nor is it, to brand everything in this bill as protectionist. One man's protectionism is another man's fair trade and I understand that. There is room for honest differences of opinion with respect to this.

The exchange rate provisions that are in this bill, the requirement for maintaining a strategic exchange reserve and the requirement that there be G–5 negotiations and so forth, are not protectionist in the slightest. I am simply saying, that those provisions speak to actions that we have already taken.

Senator **Danforth**. Under our Early Bird Rule, I have the following order of the Senators who are present Senators Chafee, Bentsen, Long, Gorton, Dodd, Sasser, Heinz, Bradley, and Cranston.

Senator **Chafee**. Thank you.

Mr. Secretary, I think the passages, you have here, dealing with concern over protectionism, are well founded. And, I want to congratulate you and especially the President and this administration for being the strongest force in the country to stand for free trade. You have a legitimate concern, that this Congress does have protectionist leanings. And, I think it is well for you to constantly raise that concern in your statements.

I have a couple of questions, here, in connection with the LDC's. Why would an American bank in the near future, anyway—I do not want to use the word ever, but, let us say in near future—want to lend to a LDC. It seems to me the banks have been pretty well burned. Dr. Sachs, who was in the midst of testifying, when you came in, suggests that the interest should be forgiven, that a good deal of the debt has been written off, so what has not been written off should be forgiven too. And, if I were a president of a bank, I just do not think I would want to get near any LDC with the American economy thriving the way it is. If I could get whatever money I had out of them, I would get it and consider it an unfortunate experience and concentrate on other investments, either in the western European countries or common market countries or in the United States.

Secretary **Baker**. Well, Senator, that is what a number of the regional banks would like to do, because they are not in so deep and they can afford to do that. I happen to think that writing off the debt or writing it down is not a solution to the debt problem, it is an admission of defeat.

Now, that is one way we can go. Maybe we can have a debate over whether that is what we ought to do. But, in my view that is simply admitting defeat. Why would some of the major money center banks consider additional loans to some of these debtors when they have some loans that are in trouble?

Just like a domestic credit, sometimes you can improve an international credit, if the debtor is willing to change his ways and improve his method of business operation. Some of these banks have a lot of loans that are under water. If the countries are willing to adopt growth-oriented economic reforms that will permit them to earn their way out, it is probably a good thing for the banks that are in heavily to look at the possibility of making sure that they have some additional capital coming in to finance the implementation of those economic reforms. That is why.

Let me say one other thing. We are not twisting any bank's arms to participate in this program. And, we are not suggesting any bailout of these banks. We are not offering World Bank guarantees. We are certainly not offering a Federal Government guaranty and we have not come here to this Congress asking for more money in connection with this plan.

Senator **Chafee**. Well, I hope you are successful. You listed 15 LDC's that were the major debtor nations. And, I think you said 11 of them are engaged bilateral talks of some type with us in connection with their debt. I hope you are successful, because these countries are tremendous markets for the United States. And, I hope it all works out. I must say, if I were a banker, I would be very nervous about my money. Let me ask you a second question.

Secretary **Baker**. Senator Chafee, there is nothing to require a bank to come up with new lending; let me just say that, before you go on. It is not something that we are going to the banks and saying, you must do this. We are saying, you may well find it in your interest to do so and if you do, please participate. Go ahead.

Senator **Chafee**. Now, the second question is—I know you have been urging Japan and West Germany to increase their domestic consumption. Why would one of those countries increase its domestic consumption if it is not in their self-interest? Solely, because they have signed on to these agreements that you mentioned before?

Secretary **Baker**. I think that some of them might consider doing that if they thought that the very existence of the world's free trading system was at stake. I think we have impressed upon our trading partners in a very forceful way the extent to which, without branding any particular element of this bill, protectionist, there is a strong protectionist sentiment building in the United States. This is quite understandable in the face of $125 or $148 billion trade deficit, depending upon which method of calculating you use.

So, I think that is why they would have an interest in working with us to iron out these external imbalances, so, that their surpluses would not be as great and our deficit would not be as great.

Senator **Chafee**. Thank you. Thank you, Mr. Chairman.

Senator **Danforth**. Senator Bentsen.

Senator **Bentsen**. Thank you very much, Mr. Chairman. Mr. Secretary, as I stated in my earlier comments before you arrived, I want to congratulate you on what you have been able to do on currency exchanges. From my way of thinking, that represents a 180-degree change in direction on the part of the administration. You have moved away from a hands-off policy to a hands-on policy.

But, frankly, I still think that is where you are on trade. I think you are on a hands-off policy. And, the word "protectionism" has been used by the administration for a substitute for trade, and, for having a trade policy.

Many of the pieces of the legislation sponsored here are not truly protectionist, but are trying to break down barriers to our products in other markets. That is what we have been working to try to achieve. We are looking at a world today with a return to mercantilism and state directed trade. We can not handle it with just a hands-off policy.

But, let me speak specifically to some of these things you have addressed. One concern I have is over the enforcement mechanism for currency values, I gather that if one country's policies are disapproved by the others, that country would be expected to use its best efforts to correct the problem. But, I look at what happened to us from 1980 to 1985, when West Germany and the Japanese were lamenting our deficit budgets through all those years. We tended to ignore them.

What mechanism do you have that is going to bring about a change in direction there? Is there any type of enforcement at all? You state none of us are ready to give up our sovereignty; how do you musolate, how do you achieve it?

Secretary **Baker**. Well, Senator Bentsen, the only thing that you will have—and I happen to think it is substantial—that you do not have now, is an agreement by all of these countries to judge their economic performance in light of economic indicators, and to measure those, perhaps on a more frequent basis, through the surveillance mechanism. They have agreed publicly to use their best efforts to correct a departure from the intended course. And, the only thing you can have, unless you are going to cede sovereignty is the possibility of peer pressure bringing about adherence to the agreement and the possibility of public pressure, bringing about adherence to the agreement.

Senator BENTSEN. Mr. Secretary, I hope that works, but I think that domestic concerns will be paramount and will be very difficult to change. I looked at the euphoria that came after the Tokyo round and how Japan was going to open up its markets. And, then I look at what has happened between our two countries on a bilateral basis and it has not been encouraging. I am very pleased, if I may, because my time is so short.

Secretary BAKER. Go, ahead.

Senator BENTSEN. Let me state that I am very pleased with the change in policy toward the Third World countries. There is no question in my mind that the IMF course, focused just on austerity, was a deadend street. It leads to political instability that is a serious problem for the entire world and particularly for us, bordering onto Mexico.

But, then I look at what you are suggesting and I know some of the limitations you are under. You speak of $10 billion a year. The interest charges of Mexico alone are going to be that much—in this year. I find it very difficult to think that you are going to turn around the massive flow of capital out of those countries and have a significant impact. I look at some of these nations today that are really chapter 11 cases. I frankly think that just rescheduling some of these loans and letting the banks continue to make their full profits is a bridge to nowhere.

Some of these countries will never pay off these loans and if that is an admission of defeat, I think it is a recognition of some of the realities that are facing in a few of those specific countries. Can you give me some encouragement in that regard?

Secretary BAKER. Yes, sir, I can. I can tell you that while not all countries are adjusting and adopting the kinds of economic reforms we have suggested, a number of them—Argentina, Uraguay, Ecuador, Colombia are making significant progress. And, therefore, just because we do not have all of them.

Senator BENTSEN. I said a few of them, I did not say all of them.

Secretary BAKER. Well, I think—Well, you are right, there are a few that are not. There are a few that are dragging their feet, but I really believe that we should not because of that, give up on this problem and simply say we are going to write off this debt. And, that is the only alternative that I have heard suggested.

Senator BENTSEN. I was very careful not to generalize on that. I think that you have a few specific countries that have not responded to the restructuring that you are recommending to them. And, I strongly agree with what you're doing. These should be more privatizing of some of the companies that are owned by governments in order to make them more effective and competitive. I see my time is up.

Senator DANFORTH. Senator Dodd.

STATEMENT OF HON. CHRISTOPHER J. DODD, A U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator **Dodd**. I commend the respective committee chairman for allowing this to be a joint hearing with the Banking Committee. I think it is very, very helpful. Mr. Secretary, let me join in the chorus of those who have commended you for activities taken since last September. I guess many of us have been saying that we only regret that the actions were not taken a bit earlier, that, in fact, much of what you have seen and are seeing in the form of legislation before the Congress and other places is as a result of, I think, inaction for an awful long time.

Let me just ask a couple of quick house cleaning questions. What about the possibility of a firm date or date certain for the beginning of formal trade negotiations? Was anything reached on that at all, that you can share with us?

Secretary **Baker**. Senator Dodd, I think that we made good progress on the trade area at the summit. We got into the communique for the first time the fact that the new round would deal with intellectual property rights, services and direct investment. We did not get the commitment of one country, with respect to the starting date of the new round, and of course, you operate there by consensus and one country can hold up agreement. But, everybody knows that there is a special ministerial meeting of the GATT in September and that matter is going to be discussed there. And, as I indicated in a previous comment, you would get very good odds if you wanted to bet on a new trade round starting. I think you will see that in September.

Senator **Dodd**. And, you sort of anticipated my next question. I noticed that the OEDC ministerial meeting and the Tokyo Summit communiques have identical language with regard to intellectual property, and services, foreign direct investment. The is specific language there that is exactly the same. Is that—was concensus reached on that? Was there a firm commitment among the seven that those issues shall be on the table, whenever those trade negotiations resume?

Secretary **Baker**. Yes, sir.

Senator **Dodd**. With regard to the foreign exchange rates, again. Going from the Plaza Agreement to the Tokyo summit, formalizing the ad hoc arrangement, both the Japanese press as well as Germany, recently in the wake of the Tokyo summit, have been statements to the effect, that the appreciation is, that we presently have, is as far as both of these countries are willing to go. And that, in fact, both countries have asked the United States to go firm at a rate of 180. Have in fact, we have been asked to hold firm at that rate, and, if so, what has been our response?

Secretary **Baker**. At a rate of what?

Senator **Dodd**. 180.

Secretary **Baker**. May I, before I answer that question, speak to one other thing you mentioned in the course of your question. You said formalizing the relationship at the Plaza.

Senator **Dodd**. Those are my words.

Secretary **Baker**. I know, I like to think we went considerably beyond that, Senator, in the sense that we called for the use of these indicators and we called for a best efforts at least basis to cure deviations from the intended course.

Senator **Dodd**. Can I add, just a further point?

Secretary **Baker**. Yes.

Senator **Dodd**. It may get to this in a second. But, why not, why did we not also decide, taking the Plaza Agreement and moving forward to set some specific targets along the way as benchmarks, recognizing best effort? But, benchmarks that could determine or least give us some framework to decide whether best efforts are reached. And, I will let you respond.

Secretary **Baker**. Well, that will be the case, because these indicators will be used and you will judge performance, taking into account those indicators. One of the indicators will be exchange rates. But, you will have growth rates. You will have inflation rates. You will have the whole range of macroeconomic indicators. So, there will be something to judge performance against.

Senator **Dodd**. Can you come back now to the question of whether we have been asked to hold firm?

Secretary **Baker**. There have been discussions between governments with respect to that. That is really all I would like to say about that. I do not want to mention any particular figure.

Senator **Dodd**. Have we agreed to a specific rate that you do not want to mention?

Secretary **Baker**. I would rather not characterize those discussions in an open session, Senator. I would be glad to do it in an executive session, if you want. I answered the question I think before you got here, with respect to—the appropriate level of the dollar. I would be glad to repeat that answer for you if you want me to.

Senator **Dodd**. No, I do not think you have to do that. I might just suggest, Mr. Chairman, would not make that sort of request on my own part, but something the committee may want to do. Decide to do at some point. Maybe have a meeting with the Secretary. I would be interested in that discussion. But, I do not want to request that in my own. I am sorry, my time has expired.

Secretary **Baker**. Thank you.

Senator **Danforth**. Senator Sasser.

STATEMENT OF HON. JIM SASSER, A U.S. SENATOR FROM THE STATE OF TENNESSEE

Senator **Sasser**. Mr. Secretary, a study produced recently describes the impact of Latin America economies in the debt on agricultural exports. And, it alludes to a forced dramatic expansion of exports to earn a hard currency to pay the debts. And, a result has been, according to this study, flooding world markets, flooded with agriculture products.

This decline in prices has been—result of decline in prices—a major contributor to higher farm problems, here in the United States. As they grow more, export more agriculture produce to deal with their external debt. Now, with agricultural banks failing at record rates, it appears to me that our farmers may be facing more direct competition from Latin American or South American farmers if we go forward with this proposal.

In my own State of Tennessee, for example, we have seen soybean production decline by 42 percent, just in the space of 5 years. Much of this, I have been told is attributable to competition from Brazilian and Argentine soybeans.

Now, as I understand the new Baker plan, the World Bank would make $9 billion in new loans. Some of these loans to Argentine and Brazil, am I correct in that assumption?

Secretary BAKER. Yes, sir.

Senator SASSER. And, there will be additional pressure then for these economies to perform to back those loans and additional pressure to increase agricultural exports. I would be interested to know, whether the administration has considered the effects of this initiative on our domestic agricultural industry and on our world market share of agricultural exports. And, if you have, can you tell me what you see as the likely effects of increasing the debt of these agricultural countries.

Secretary BAKER. But, we have, Senator, first. And, second, we are, I think, required by law to take such action. Whether we are required or not, we nevertheless do make it a point to vote against loans that have to do with projects for the production of commodities in oversupply. The thrust of the Program for Sustained Growth is that the debtor countries will agree to implement some macroeconomic structural adjustment policies.

The World Bank will get away from so much development and project lending and will move toward structural adjustment lending. And, in the course of the development of policy framework papers for these countries at the World Bank and the IMF, emphasis is on diversification into areas that are not in oversupply.

Senator SASSER. Well, Mr. Secretary, how are we going to convince the Brazilians, the Argentinians not to produce more soybeans, for example, to apply against their foreign debt.

Secretary BAKER. The loans from the multilateral institutions will be keyed to and geared to structural adjustments of those economies. They will be disinclined to make certain loans, just like on copper projects. We try and dissuade lending by the multilateral institutions on projects for copper or agricultural projects that are in oversupply.

Senator SASSER. Well, let me shift gears here, because time is short. Mr. Secretary, Hobart Rowan, the very respected Washington Post financial writer, wrote an article entitled summit intentions, that appeared in the Washington Post, that appeared on May 4. In that article, Mr. Rowan states that the Japanese Finance Minister asked for help in early April to stabilize the yen of 180 to the dollar.

The article went on to say, many experts in Japan believe the dollar's rapid decline could result in a withdrawal of Japanese investment, which is now helping to finance the United States budget deficit. I think last year, it financed somewhere around 20 to 25 percent of it. If this Japanese investment leaves the country, we could see a rapid runup in interest rates.

I have a two-part question. Has the Japanese Finance Minister sought our help or United States help or your help in keeping the yen from rising further? And do you think if the yen continues to appreciate against the dollar, will it cause the withdrawal of Japanese short-term investment in the United States?

Secretary **Baker**. Well, the first question, Senator, falls in the ambit of my prior answer—there have been discussions between governments. I would rather not go into those publicly, but I would be delighted to talk to you in executive session. It is our view that the decline of the dollar to date has been orderly. It has not been precipitous. There has been no freefall. We have not experienced any difficulty in placing government securites, in financing the operations of U.S. Government and we do not anticipate experiencing any difficulty.

Senator **Sasser**. My time has expired. Thank you, Mr. Chairman.

Senator **Danforth**. Senator Heinz.

Senator **Heinz**. Mr. Chairman, thank you. First, as your cochairman of this hearing, representing the Banking Committee's International Finance and Monetary Policy Subcommittee, I want to apologize for my absence earlier in the hearing. Secretary Baker, however, is a good witness, as he knows where I was. He was keeping an eye on me down in the Oval Office, up until the time he left. He beat me out by about 3 or 4 minutes. But, I do apologize to you, Mr. Chairman, for not having been here at the outset.

Clearly the trade deficit that we have remains enormous. Many U.S. industries that used to compete abroad, have given up or moved overseas. Those that have remained behind have been on the receiving end for 3 or 4 years of very tough foreign competition.

Many of those industries, probably have had their future compromised, their ability to form capital, their ability to stay modern, compromised. But, I must say, that despite those problems, I do not agree, Mr. Secretary, with what Senator Bentsen said a moment ago, that you have gone about business as usual. I do not think that is true at all.

I do not think the Baker initiative of last year is business as usual. I do not think that what was included in your communique at the Tokyo summit is business as usual, either with respect to the understandings on dollar volatility and management or the coordinated approach to summit nation economic performance.

But I have some serious reservations about how able we are going to be to implement the policies that you have very ably set forth and created a framework for. I worry about the willingness of Germany and Japan to coordinate their economic policies and stimulate their economies.

I am quite concerned that we in this country may not have adequate capital formation policies. We have a low real return on capital in this country. We have a low capital formation rate. That may continue to be a drag on us. We may not have paid enough attention to this in our domestic policies. Senator Sasser, I think was referring to this.

I also have some concerns about the compatibility of a U.S. goal to export more and import less, that would be the consequence of an effective trade policy, with the fact that as the LDC's get their house in order and service their massive debts, they will also want to export more and import less.

And, finally I have some concerns with respect to LDC debt management and our ability to implement the Baker initiative. On the one hand the Baker initiative urges, in conjunction with the other international lending institutions and more discipline by the LDC's involved, a more forthcoming, lenient lending attitude by U.S. banks. How well that fits with the regulators' agenda, which includes relating risks to capital and downgrading loans to debtor countries, is a major issue.

I am going to run out of time as I set the stage for my first question, which you only partially answered in response to Senator Chafee. That is, how are we going to get economic policy coordination without the help of Japan and Germany? You seemed to say to Senator Chafee that Congress has to be protectionist and that was what was going to drive them. Is that what we have to do?

Secretary **Baker**. No, that is not what I was suggesting. But, I was suggesting that I think some of our success to date has been because they realize, that we cannot politically sustain the kind of trade deficits that have been running in this country. I happen to think that is one reason we reached unanimous agreement at the Plaza. I happen to think that is one reason we were able to do what we were able to do at the Tokyo summit. So, I think that they recognize and understand that it is in their self-interest as well as ours to smooth out these imbalances. That there be less of a surplus as far as they're concerned and less of a deficit as far as we're concerned in our trade figures.

Senator **Heinz**. My time has expired, but I want to pursue that when we come back.

Senator **Danforth**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman. Mr. Secretary, first of all, let me compliment you on the summit. And let me say that I was very pleased to hear the magic words in the summit communique supporting a managed floating exchange rate system. I think that is enormous progress. We are heading in the right direction and you are to be complimented for being forthright and stating that direction. I must say, though, that there is another area about which I would like to ask a few questions, and that is on the third world debt question and the Baker initiative.

As I understand it, the Baker initiative is about $20 billion in new private bank lending over a 3-year period, and $9 billion in developmental loans, plus commitments for internal changes in the countries of Latin America. Is that basically what it is?

Secretary **Baker**. And some changes in the multilateral institutions.

Senator **Bradley**. Yes.

Secretary **Baker**. Methodologies, too. That is right.

Senator **Bradley**. One of the things that concerns me, is the effect of the debt crisis on American jobs. The fact of the matter is, in the last 3 years, we have lost about 400,000 jobs in the export sector, because our export markets have been destroyed in Latin America. And, we have lost about 600,000 jobs because of Latin American imports into the United States. So, our debt policy has produced the loss of 1 million jobs in the United States.

And, you know it is startling, because we sit here in the committee and we talk about unfair foreign trade practices, and about

Japan, and about this country and that country. Yet, if you look at the increase in bilateral trade deficits in the last several years, you will find an $18 billion increase in the trade deficit with Japan.

The Institute of International Economics and others have estimated that if we eliminated all unfair trading practices, we would decrease our trade deficit by about $15 billion. Yet with Latin America in the last 3 years, we have increased our trade deficit by $23 billion. My question to you is whether that is the way it was supposed to have worked?

Secretary **Baker**. Well, I do not know what you are talking about, when you say "it." But, let me remind you our debt proposal was announced last October in Seoul to try to deal with the very problem that you have pointed up. What happened there was not a consequence of any policy of the U.S. Government.

The fact of the matter is, you had countries down there, that were borrowing far beyond their means. And, you had banks in this country and other industrialized countries, that were lending far more than they should have lent. So, it was not governmental policy.

Senator **Bradley**. So, basically, you are saying that the Baker plan is a response to the numbers that I have laid out.

Secretary **Baker**. Yes, sir.

Senator **Bradley**. All right.

The Morgan Guaranty financial markets report states that in the worst 3 years of the debt crisis, the banks made about $45 billion in net new loans to Latin America. So, what is the Baker plan going to produce, if in the worst 3 years, they lent $45 billion, whereas the Baker plan calls for them to lend just $20 billion.

Secretary **Baker**. You are comparing apples and oranges. The $45 billion is a part of the problem. The $29 billion would be part of the solution, provided you got action on the other end by the debtor countries. The banks were making loans willy-nilly without any requirements with respect to economic reforms and without any assurance, whatsoever, the debtor countries would have an economy that would permit them to pay those loans back. Our initiative requires first and foremost, market-oriented, growth-oriented economic reforms.

Senator **Bradley**. Would not the bank that was going to make the loans anyway, simply say, look we are complying with the Baker plan?

Secretary **Baker**. Well, the bank is not going to make the loans unless they get the economic reforms, or——

Senator **Bradley**. You are saying that absent economic reforms, that there would be no new lending to Third World countries, even though in the worst 3 years of the whole crisis, net new lending was $45 billion?

Secretary **Baker**. In my opinion, they have learned their lesson. And, there would be probably no new commercial bank lending in the absence of reforms. I think that was the point Senator Chafee was making.

Senator **Danforth**. Mr. Secretary, thank you very much for your testimony this morning.

Senator **Baucus**. Mr. Chairman. May I ask some more questions?

Senator **Danforth**. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Thank you very much and thank you——

Senator DANFORTH. Thank you very much for your testimony, so far this morning. [Laughter.]

Senator BAUCUS. Mr. Secretary, when Senator Sasser asked you some questions about some of the same problems as Senator Bradley, I noticed you responded in part by saying that it is U.S. policy to vote against loans which have the effect of increasing the agricultural surpluses. I——

Secretary BAKER. Commodities in oversupply, as I understand it.

Senator BAUCUS. All right, I am asking because the JEC report that I referred to basically says, that a good example of the adverse impact the Baker plan would have is the recently announced $350 million World Bank loan to Argentina. That loan was conditioned on Argentina reducing its tax and agricultural exports in order to expand the amount of land in that country devoted to wheat and soybean production. I am just wondering what the administration policy is? Is it in favor of these kinds of loans or not?

Secretary BAKER. Well, Senator, you will find that that loan negotiation was started before we announced our proposal. And, I am not sure to be very honest with you, how we voted on it. But, it was not a project loan, it was an overall sectoral adjustment loan; it had to do with all agriculture, as I understand it, and not just soybeans.

Senator BAUCUS. That is right. Argentina produces soybeans and wheat and products that are in direct competition with American soybeans and wheat. I was a little concerned about your response to Senator Danforth's question about Canadian exchange rates. You said with regard to the fact that Canada pegs its exchange rate to the U.S dollar that there was not a lot we could do about that. That alarms me because, in effect, the administration is agreeing to fixed exchange rates with Canada and with other countries that do peg their rates to the U.S. dollar.

Brazil and Argentina recently devalued their currencies and then pegged them to the U.S. dollar. That is a double whammy against us in one sense. It is a devaluation which hurts our industries and it's pegged; it's fixed. I am very curious as to how the administration deals with that kind of inconsistency. On one hand, you have managed rates in some kind of a target zone and on the other hand, you have fixed rates, particularly with countries that export very heavily to the United States.

Secretary BAKER. We do not have fixed rates in the sense, that we are sitting down and agreeing, that this is going to be the relationship; it is just that the dollar is the world's major reserve currency now. Those countries that tie to the dollar take action in relation to what the dollar does. It was not done by agreement. We are not agreeing to fixed exchange rates with those——

Senator BAUCUS. Canada has now been brought into the club, as I understand it. Canada and Italy have made the G-5 a G-7, as I understand it.

Secretary BAKER. That is right.

Senator BAUCUS. It seems to me that the administration has a responsibility to ask Canada to adopt policies that do not adversely affect the U.S economy. For example, Canada has tight investment restrictions.

Secretary **Baker**. Yes; they do.

Senator **Baucus**. The Canadian growth rate is higher than the United States. It seems to me there are ample reasons why Canada need not peg its currency 30 percent below the U.S dollar.

Secretary **Baker**. Well, those investment policies should be the subject of a great deal of attention in the negotiations over a free trade agreement with the Canadians. I do not think we ought to look just at the trade side, we ought to look at the investment side as well. And, we ought to get into that in quite some depth. And, I am confident, Senator, that we will.

The point that you make is a good one about Canada in the aftermath of the Tokyo summit communique. Because, as a member of the club, they will have to come up with forecasts with respect to exchange rates. It might be determined at some point that it might be inappropriate, just to follow the U.S. dollar. But, my point is that with respect to Hong Kong and Taiwan and Canada and some of those other countries, we do not sit down and fix exchange rates with them. They simply take action in relation to what happens to the dollar.

And, I hope I made the point that the drop in the dollar will have a beneficial consequence to us even as far as those countries are concerned. Because those countries will now have better markets elsewhere for their exports.

Senator **Baucus**. Could I ask one final question? When are we going to see the economic data on which administration policies will be based in setting exchange rates?

Secretary **Baker**. There is no agreement to publicize that data, Senator. That is not part of the agreement. That is one of the matters that we will have to deal with in the course of implementing the agreement at Tokyo.

Senator **Baucus**. When will that data be available, if not public, to the administration.

Secretary **Baker**. Well, we do not even know, yet, when the first meeting is going to be. We are in the process of preliminary discussions to determine when we should have the first meeting to follow up on the Tokyo summit communique. But I want to make it clear, there has been no agreement that the data that will be used in those surveillance exercises will in fact be made public. I would think there would be some likelihood, that it would probably leak out.

Senator **Baucus**. Some likelihood. Thank you.

Senator **Heinz**. Very well, thank you, Senator Baucus. First, I am going to insert an opening statement, that I would have made, had I been here at the outset.

I want to return, Mr. Secretary, to a few other questions, that I suggested in my remarks a few minutes ago, particularly. The question of whether Germany or Japan are going to be of assistance. We have been talking about that for quite a while. We are familiar with a variety of Japanese long-term macroeconomic shifts, but it seems to me that in the immediate future, that is to say this year, next year, or maybe the year after, it is highly un-likely that we are going to see much in the way of help through coordinated economic policies from Germany and Japan.

I hope I am wrong, but your answer to me was, well, they have to understand there is a problem and there understanding will bring atonement I hope that is right, but I remain somewhat skeptical.

Secretary **Baker**. Senator.

Senator **Heinz**. I do not want to get into an argument with you about it, because I think it is a question of waiting to see what happens.

Secretary **Baker**. Well, to some extent let us wait and see, but to some extent we have already seen. On the exchange rate side, I think you would have to agree that there has been cooperation and better coordination with those two countries as well as others.

Senator **Heinz**. That leads me to another question, and that is the extent to which we think our trade imbalance with Japan is structural, and to what extent is it really susceptible to reduction through the weakening of the dollar vis a vis the yen by 25 to 35 percent? Do we expect that that shift is going to significantly change the trade deficit that we run with Japan?

Secretary **Baker**. I think you will see improvement in our trade deficit with Japan, beginning this fall and continuing through next year. I think after that, we will have pretty much seen all of the effects of the changes in the exchange rate relationship. And clearly some of it is structural, Senator Heinz.

Senator **Heinz**. That deficit in the last year ran at about a $49 billion rate. Is that not right?

Secretary **Baker**. That is about right.

Senator **Heinz**. Would you expect that to tail off to 40, 35?

Secretary **Baker**. I do not want to put a figure on it, I will put a figure on the overall U.S. trade deficit. On a balance-of-payments basis, it is our view that we would see, roughly, a $125 billion deficit in 1986, because there is going to be an increase in the first half of this year and then a decrease in the second half. So, the deficit will be roughly the same as it was in 1985. In 1987, I think you will see it fall on a balance-of-payments basis, not a census basis, to below $100 billion in the $95 billion range.

After that, I think we will have seen all we are going to see as a consequence of the exchange rate changes. To answer your original question, a large part of our trade deficit with Japan is structural. That is why we have been encouraging them to increase domestic demand and they have indicated a willingness to move in that direction. That is why we have had yen-dollar talks with them and that is why we have seen the yen become more of an international currency and that is why you have had the Maekawa report, quite frankly.

Senator **Heinz**. Mr. Secretary, as you know, I think your policies and your goals are excellent. The question is, Whether or not the people from whom we need cooperation are going to supply it? Let me shift to a slightly related problem. It is trade related. Are our trade goals, which are to reduce imports and increase exports, not through protectionist activities but through macroeconomic policies compatible with our goals for the LDC debtor countries? If these countries are to service additional debt, in effect they must increase their exports and decrease their imports. My question is, If everybody, is decreasing imports, and increasing exports, and Germany and Japan and the other major trading nations are sitting on the sidelines saying we will reinflate our economy in a year or two, who is going to buy all those exports?

Secretary **Baker**. That is not what Japan is saying. They have said for some time that they are going to find ways to increase domestic demand. They are going to become less of an export driven economy. And, what you have to have, and you quite properly pointed out, are surplus countries agreeing to conduct their policies in such a way that they import more. So, we're able to export and the LDC's are able to export more.

Senator **Heinz**. I have one last, very specific problem for you. I have been working on the war chest mixed credit problem for quite some time. I was very pleased to see it in your statement as one of three areas in which you do support legislation. That you support the enactment of the war chest legislation aimed at eliminating mixed credits. As you know, Dr. Mulford reported to me after the The OECD meeting that Japan's resistance to compromise on mixed credits was a key stumbling block to a mixed credit agreement. The issue did not appear as far as I can tell in the summit communique. Was that issue raised in Tokyo? Was any progress made and what are the prospects for resolution on that issue?

Secretary **Baker**. The issue was raised during the course of our bilateral discussion with the Japanese. We indicated that we still thought that this was a predatory practice that ought to be ended. That we had legislation pending here and we appreciate very much the sense of the Senate and the House resolutions that were passed just before we left for Tokyo, because that helped us over there. And, we got a commitment from the Japanese to sit down and address this matter in good faith and expeditiously within the context of the OECD and we are looking forward to those discussions.

Senator **Heinz**. Mr. Secretary, did the President raise it with Prime Minister Nakasone?

Secretary **Baker**. My recollection is that it was raised at my level, Senator, and it was not raised in the meeting that the President had with the Prime Minister.

Senator **Heinz**. Secretary, thank you. Senator Bradley.

Senator **Bradley**. Mr. Secretary, just two quick questions. On the $20 billion in new commercial bank lending, do you think that there is a likelihood that 3 or 4 years out, some bank is going to sue the Treasury on the grounds that, its participation or extending of new loans was pursuant to an implied Government guarantee under the Baker plan? When you see that as a ground for——

Secretary **Baker**. Senator, as a lawyer, I know very well that anybody can sue anybody else for anything. But, that would be one that seems to me you would really have to stretch pretty far and I would not take it on a contingent fee, because I think the Treasury would plead governmental immunity and come out alright. But, now, I will give you a serious answer. No, I do not see that happening. We have said over and over and over again, the banks will participate only if they see it is in their self-interest to do so and we do not want them to participate if they do not see it in their own self-interest.

Senator **Bradley**. All right. Just, one last question. Again, getting back to the amount of banklending to Central America in the 3 worst years of the crisis, that is, $45 billion. Under your plan, you suggest $20 billion in new lending. Is the purpose of the plan to reduce the amount of lending to Third World countries?

Secretary **Baker**. No, the purpose of the plan is to give them assurance of sufficient capital flows so that they can go forward with the economic reforms, that are necessary if they are ever going to have an economy that will earn their way out of debt. The $45 billion, I think everybody would agree was a terrible mistake. The countries would agree, the banks would agree. We certainly do not think it was prudent.

Senator **Bradley**. What is the leverage to get them to do that, that is my question. What is the leverage that you have through the Baker plan to get them to make the additional loans?

Secretary **Baker**. To get the banks to make the loans or to get the countries——

Senator **Bradley**. The banks. What is the leverage——

Secretary **Baker**. We are not seeking leverage, Senator. The banks have some bad loans. We think that they can improve those credits if the countries will reform their economies, and we are offering our good offices in dealing with the multilateral institutions and to some extent with the countries to try and help move them along toward adopting those reforms. If the banks do not want to lend, they should not lend. They should just go out and write that debt off and take their hicky and go on down the trail.

Senator **Bradley**. So, you view your role primarily as an advocate. You are not a——

Secretary **Baker**. No. Let me tell you what I view our role is, if I may.

Senator **Bradley**. It is difficult for me to see how it will happen if the bank does not want to do it——

Secretary **Baker**. It does not do it.

Senator **Bradley**. The bank does not have to do it.

Secretary **Baker**. That is correct.

Senator **Bradley**. The banks—when that was the case in the previous 3 years, loaned $45 billion.

Secretary **Baker**. That is right. They made some bad mistakes.

Senator **Bradley**. Are you saying that they will not loan anything?

Secretary **Baker**. They might not, they might loan the full twenty if they see that they are going to get reforms that will permit them to get their original nut back, plus the additional 20, they will loan. But, let me tell you why we are doing this. Why we suggested this proposal.

We think the LDC debt problem is an integral part of the trade problem. As I mentioned in my statement, we have I think a comprehensive, international economic policy strategy. We believe in aggressive enforcement of the unfair trade laws of the United States. The President is the first President in history to self-initiate 301 cases. We are going to retaliate against the EC on the Portugal thing. We have the war chest up here to stop that predatory practice. We dealt, I think with the dollar problem. We are dealing with it and have dealt with it at the Plaza and at the summit.

We have the debt problem that is the third element of our international economic policy strategy and it is important to try and deal with that problem, as opposed to simply saying we are just going to write that off or to let those economies down there go down the tubes and perhaps see some of those fragile democracies, which mean so much to us from a geopolitical standpoint go down the tubes as well.

Senator BRADLEY. When you say you want to get their economies growing again, does that imply you want to see privatization in those economies?

Secretary BAKER. We want to see privatization. We want to see them adopt the kinds of things that will restore capital flight. If the——

Senator BRADLEY. Tax cuts?

Secretary BAKER. Tax cuts, private——

Senator BRADLEY. Cuts in the minimum wage?

Secretary BAKER. Absolutely. Elimination of some of their bureaucratic rules and regulations. Some of their so-called structural rigidities. Those are the kinds of things we would like to see happen.

Senator BRADLEY. A lot of the Latins that I speak to say that that basically means attacking the middle class that has been created in the last 15 years. Are you worried about political instability in Mexico?

Secretary BAKER. Some of those measures will require a certain degree of political will, but not nearly as much in my view, as some of the austerity measures which we were suggesting before.

Senator BRADLEY. Thank you.

Senator HECHT. Mr. Secretary, we thank you very much for your testimony. We look forward to seeing you on another occasion and good luck on all the work you have to do.

Secretary BAKER. Thank you, Senator.

[The prepared statement of Hon. James A. Baker III follows:]

FOR RELEASE UPON DELIVERY EXPECTED AT
10:45 A.M., MAY 13, 1986

Statement by the Honorable James A. Baker, III
Secretary of the Treasury
before the
International Trade Subcommittee of the
Senate Finance Committee
and the
International Finance and Monetary
Policy Subcommittee of the
Senate Banking Committee

May 13, 1986

Mr. Chairman, I welcome this opportunity to discuss the Administration's approach in dealing with large U.S. trade deficits, particularly as they reflect problems relating to the exchange rate system and the debt situation in the developing countries. Before I begin, let me offer my congratulations to the Finance Committee for successfully completing work on a major bill of fundamental tax reform.

The Administration recognizes and shares congressional concerns about the impact of exchange rate volatility and LDC financial difficulties on the international competitive position of American industry, agriculture, and labor. We have been, and are, actively pursuing a comprehensive strategy to address this problem. I am pleased to be here today to describe our approach and to encourage your support for it.

Last September, the President presented a comprehensive trade policy action plan. Our approach includes four critical elements: strengthening the functioning of the international monetary system through closer economic cooperation; promoting stronger and more balanced growth among the major industrial nations; improving growth in developing nations with a heavy debt burden; and last, but not least, ensuring that trade is not only free but also fair and promoting open markets world-wide. It is our belief that this is the preferred path to reducing the U.S. trade deficit and will have long-range positive effects on the U.S. economy and world stability.

Today, my remarks will focus on the progress we have made in implementing the President's trade strategy and restoring this country's competitive position. In this context, I will offer some perspective on the agreements reached at the Tokyo Summit last week. I understand that Ambassador Yeutter will appear before you tomorrow to testify on one key aspect of our trade strategy, aggressive participation in a new round of trade negotiations.

Progress and Opportunities

We are making significant progress in establishing the fundamental conditions necessary to achieve and maintain a sound and growing world economy, more balanced trade positions, and greater exchange rate stability.

- The Plaza Agreement last September has resulted in exchange rate relationships that better reflect underlying economic conditions. The Japanese yen and German mark have now appreciated more than 60 percent from their recent lows in February 1985. The dollar has more than fully offset its earlier appreciation against the yen; and it has reversed three-quarters of its appreciation against the mark.
- The Plaza Agreement also contributed to movement toward stronger, more balanced growth among the major industrial countries, including policy commitments to that end. Efforts to fulfill those undertakings are ongoing. The favorable economic convergence which was the focus of the Plaza Agreement is being realized, with consequent narrowing of the "growth gap" between the U.S. and its major trading partners.
- Inflation has been cut sharply and is expected to stay low, in part reflecting the effects of the sharp reduction in oil prices. This has facilitated a substantial reduction in interest rates and enhances prospects for further declines.
- We now expect the deterioration in our trade position to halt this year, and we look forward to substantial improvement next year. Exchange rate changes take time to work their way through our economic system, as businesses and consumers gradually adjust their plans. Next year, as the impact of these changes is more fully felt, with assistance from the decline in oil prices, our trade and current account deficits should drop below $100 billion, or nearly one-third below our projections as recently as last autumn.
- The U.S. has launched a major initiative to strengthen the international debt strategy. Our proposals for

growth-oriented reforms in the debtor countries have gained wide support and have begun to be implemented.

- Preparations are well advanced for launching the new round of multilateral trade negotiations, with a Ministerial to be held this September. Our Summit partners agreed in Tokyo to the U.S. proposal that the new round should include services and trade related aspects of intellectual property rights and foreign direct investment.

Still, problems remain. The scars of a decade of economic turmoil are deep, and they cannot be easily or quickly erased. The distortions to our economies from the oil shocks, rapid inflation and the recessions of the 1970s and early 1980s have required us increasingly to address structural problems that demand time to correct. Unemployment remains high in many countries, and large domestic and external imbalances persist.

Uncertainties about the future behavior of exchange rates have also been prevalent, reflecting deficiencies in the international monetary system that gradually intensified over the years. We know also that the debt problems of the developing world, accumulated over a decade or more, cannot be resolved in a few short months.

And we know protectionist pressures remain strong. We recognize the need to address related problems -- in our monetary system, in our arrangements for international economic cooperation, in the developing countries -- if we are to contain those pressures and work toward more open and fair markets.

The progress that has been achieved in the general economic environment, however, provides a golden opportunity to resolve these remaining problems. Success inspires confidence that we can go further. At the Tokyo Summit, President Reagan and the heads of the other major Free World democracies manifested the political will and leadership to confront the tasks that remain.

Strengthening International Economic Policy Coordination

The Plaza Agreement and subsequent coordinated interest rate reductions evidenced the willingness and ability of the major industrial countries to cooperate more closely on their economic policies. At the same time, experience of the past year demonstrated that exchange rate changes alone could not be relied upon to achieve the full magnitude of adjustments required in external positions. It had become increasingly more apparent that closer coordination of economic policies will be required to achieve the stronger, more balanced growth and compatible policies necessary to reduce the large trade imbalances that remain and foster greater exchange rate stability. For this purpose, we went to Tokyo seeking to build upon the framework embodied in the Plaza Agreement and to establish an improved process for achieving closer coordination of economic policies on an ongoing basis. I believe we succeeded.

The international monetary arrangements that have been in place since the early 1970s contain a number of positive elements, particularly a necessary flexibility to respond to economic shocks. However, this flexibility went too far, allowing problems to cumulate and countries to pursue policies without adequately considering the international dimensions of their decisions. The agreement reached at the Tokyo Summit seeks to combine needed flexibility with a greater liklihood that remedial action will be taken to deal with problems before they reach disruptive proportions.

The arrangements that were adopted involve a significant strengthening of international economic policy coordination aimed at promoting non-inflationary growth, adoption of market-oriented incentives for employment and investment, opening the trade and investment system, and fostering greater exchange rate stability. Details of the new procedures will, of course, have to be worked out in subsequent discussions. However, I see the enhanced surveillance process working as follows:

> First, the measures for use in assessing country goals and performance will be agreed upon by the countries participating in the enhanced surveillance process. As stated in the Tokyo communique, a broad range of indicators would be utilized in order to achieve the comprehensive policy coverage necessary to insure that the underlying problems, not just the symptoms, are addressed. These indicators would include growth rates, inflation rates, unemployment rates, fiscal deficits, current account and trade balances, interest rates, monetary growth rates, reserves, and exchange rates.
>
> Second, each country will set forth its economic forecasts and objectives taking into account these indicators.
>
> Third, the group would review, with the Managing Director of the International Monetary Fund, each country's forecasts to assess consistency, both internally and among countries. In this connection, exchange rates and current account and trade balances would be particularly important in evaluating the mutual consistency of individual country forecasts. Modifications would be considered as necessary to promote consistency.
>
> Fourth, in the event of significant deviations in economic performance from an intended course, the group will use best efforts to reach understandings on appropriate remedial measures, focusing first and foremost on underlying policy fundamentals. Intervention in exchange markets could also occur when to do so would be helpful.

As you know, countries have been developing individual economic forecasts for years. Moreover, the IMF consults with individual countries on a regular basis regarding their economic policies and performance. What is new in the arrangements adopted in Tokyo is that the major industrial countries have agreed that their economic forecasts and objectives will be specified taking into account a broad range of indicators, and their internal consistency and external compatibility will be assessed. Moreover, if there are inconsistencies, efforts will be made to achieve necessary adjustments so that the forecasts and objectives of the key currency countries will mesh. Finally, if economic performance falls short of the intended course, it is explicitly agreed that countries will use their best efforts to reach understandings regarding appropriate corrective action.

The procedures for coordination of economic policy were further strengthened at the Summit. A new Group of Seven Finance Ministers, including Canada and Italy, was formed in recognition of the importance of their economies. At the same time, the Group of Five has agreed to enhance its multilateral surveillance activities.

In sum, Mr. Chairman, we have agreed on a more systematic approach to international economic policy coordination that incorporates a strengthened commitment to adjust economic policies. I am hopeful that the spirit of cooperation that made this agreement possible will carry over to its implementation. If so, we can look forward to greater exchange rate stability, enhanced prospects for growth, and more sustainable patterns of international trade.

Improving Growth in Debtor Nations

Successful economic policy coordination among the industrial nations complements our efforts to deal with LDC debt problems by strengthening the world economy, creating the conditions for lower interest rates, and helping to improve access to markets.

Recent improvements in the global economy are already making a significant contribution to developing nations' growth prospects and will substantially ease their debt service obligations. Stronger industrial country growth and lower inflation, for example, will add nearly $5 billion to developing nations' non-oil exports and reduce their import costs by approximately $4 billion this year. The sharp decline in interest rates since early 1985 will reduce their annual debt service payments by about $12 billion. The decline in oil prices will also save oil-importing developing nations an additional $14 billion annually.

At the same time, however, developing countries, particularly debtor nations, must position themselves to take advantage of these improvements by putting in place policies to assure stronger, sustained growth for their economies over the medium and longer term. As you know, the "Program for Sustained Growth" for the major debtor nations proposed by the U.S. in Seoul was premised on credible, growth-oriented economic reform by the debtor nations, supported by increased external financing.

In Tokyo, the Summit leaders welcomed the progress made in developing the cooperative debt strategy, in particular building on the United States' initiative. They emphasized that the role of the international financial institutions will continue to be central and welcomed moves for closer cooperation between the IMF and the World Bank, in particular. The debt initiative has also received strong support from the international financial institutions, national banking groups in all major countries, and the OECD Ministers, as well as the key IMF and World Bank Committees representing both debtor and creditor countries.

The adoption of growth-oriented macroeconomic and structural policies by the debtor nations is at the heart of the strengthened debt strategy and crucial to sustained growth over the longer term. Special emphasis needs to be placed on measures to increase savings and investment, improve economic efficiency, and encourage a return of flight capital. A more favorable climate for direct foreign investment can be an important element of such an approach, helping to reverse recent declines in net direct investment flows. Such inflows are non-debt creating, provide greater protection against changes in the cost of borrowing, and can help improve technology and managerial expertise.

Similarly, a rationalization and liberalization of debtors' trade regimes can contribute to improved efficiency and productivity for the economy as a whole. Together with other growth-oriented measures to assure more market-related exchange rates and interest rates, to reduce fiscal deficits, to improve the efficiency of capital markets, and to rationalize the public sector, such measures can help improve growth prospects, restore confidence in debtor economies, and encourage the return of flight capital.

Such policy changes will take time to put in place and can't be expected to occur overnight. The process of implementing these reforms will also be much less public than the series of announcements to date supporting the debt initiative. Implementation will take place through individual debtors' negotiations with the IMF, the World Bank and the commercial banks. We expect these negotiations to place greater emphasis on dealing with current debt problems through a medium-term, growth-oriented policy framework. This process is already underway. The IMF, for example, has existing or pending arrangements with 11 of the 15 major debtor nations, while the World Bank has structural or sector loan negotiations underway with 13 of these nations and has recently extended loans to

Ecuador, Argentina, and Colombia to support adjustment efforts in some of their key sectors.

As the Summit communique noted, sound adjustment programs will need to be supported by resumed commercial bank lending, flexibility in rescheduling debt, and appropriate access to export credits. Once debtor nations have designed economic reform programs to improve their growth prospects that have Fund and Bank support, it will be critical for the commercial banks to fulfill their pledges of financial support for these programs. The industrial nations must also cooperate regarding resumption of export credit cover to countries implementing appropriate adjustment policies.

We believe prompt enactment of legislation enabling U.S. participation in the Multilateral Investment Guarantee Agency would also make an important contribution to international efforts to improve the LDC investment climate and to facilitate new flows of foreign direct investment.

In addition to the strong global support for our initiative with respect to the major debtors, we are also very pleased with the recent action of both the IMF and the World Bank on the Trust Fund initiative to assist low-income developing nations, including Sub-Saharan Africa. This constitutes a major step forward in Fund/Bank cooperation and a positive context for current negotiations on IDA VIII. We look forward to its implementation so that a sound basis of growth can be established in these countries as well.

The Program for Sustained Growth is important because it touches on a wide range of U.S. interests, but paramount among these is its importance for U.S. trade. As you know, the debt crisis has had a direct impact on U.S. exports. U.S. exports to the 15 major debtor nations peaked at $40 billion in 1981. However, this reflected an international economic environment which was clearly not sustainable. Our exports to these countries fell sharply to $23 billion in 1983, as the debtor nations were unable to maintain previous import levels in the face of financial constraints and slower export growth.

The international debt strategy adopted in the wake of the debt crisis has helped to place the debtors' economies on a sounder footing and to permit a resumption of import growth at a more sustainable pace. U.S. exports to the major debtor nations have increased by 18%, or $4 billion, during the past two years and can be expected to improve further in response to both recent exchange rate changes and stronger growth in the debtor economies. The adoption of growth-oriented economic reforms, supported by increased financing from the international community, as envisaged by the debt initiative, will help to enhance both growth prospects and imports.

It will also be important, however, for the United States and other industrial nations to maintain open markets for LDC exports to permit them to earn the foreign exchange necessary to increase imports. The process of increasing growth and trade is an interactive one. We cannot expect to reap the benefits of stronger growth and increased trade abroad if we close our markets at home.

Promoting More Fair and Free Trade

Open markets are essential to our overall international strategy of economic adjustment and policy coordination. At the Tokyo Summit last week, the leaders of the Free World's major industrialized nations recommitted themselves to maintaining an open multilateral trading system, recognizing that:

- Open markets promote economic growth world-wide. We have only to review the Depression years to see the effects of closed markets.
- They provide debtor nations with markets for their exports that are essential if they are to service their debt and, in turn, serve as markets for U.S. goods and products; and
- Open markets facilitate our efforts to adjust large, unsustainable external imbalances among the industrial nations.

The Administration is committed to maintaining an open U.S. market and ensuring a free but fair international trading system. To implement our trade policy, we are supporting the new GATT round of trade negotiations to reduce barriers abroad. As mentioned, in the new round we will notably be seeking new GATT rules covering services, intellectual property protection, and international investment.

President Reagan and the others at the Tokyo Economic Summit pledged to work at the September GATT Ministerial meeting in Geneva to make decisive progress in launching the new round. We are also starting negotiations to remove barriers to trade and investment between the United States and Canada.

We are pursuing an aggressive program against unfair trade practices. President Reagan is the first president to self-initiate action under his retaliatory authority against such practices, including cases involving Japan, Brazil, Korea and Taiwan. The President has also announced that, unless we are able to resolve our dispute with the EC over its new restrictions affecting our farm exports to Spain and Portugal, we will respond in kind.

Our aggressive policy against unfair trading practices has already met with considerable success. We have settled disputes involving the EC's subsidies for canned fruit, Japan's footwear and leather import quotas, Taiwan's import monopoly for liquor and tobacco, and Korea's restrictions on foreign motion pictures.

In sum, I strongly believe that our policy of free but fair trade is working and is in our overall economic interest.

Legislation

At this point, Mr. Chairman, I would like to address the question of proposed international finance and trade legislation, such as S. 1860. I can well understand your frustration over our trade deficit. And I can sympathize with a desire to respond to constituent requests for action by passing legislation. However, certain modifications in our trade law will not eliminate the trade deficit and may actually make it worse.

The answer to our trading problems is a comprehensive international economic policy strategy that addresses international trade, monetary and debt issues in a coordinated fashion and involves the cooperation of other nations. We have developed such a strategy, as I have discussed here today, and we are implementing it.

The exchange rate and policy coordination sections of S. 1860 raise the right issues and point in the right direction, but they are now out of date in light of the agreement reached at the Tokyo Summit.

We are, of course, prepared to engage in thorough and meaningful discussion with the Congress on all pending legislation. And, as previously indicated, the Administration already supports legislation to:

- o provide additional protection to the intellectual property rights of U.S. firms and individuals;
- o alter our antitrust laws to help both our export and import sensitive industries; and
- o provide a war chest to improve U.S. export opportunities by negotiating an end to tied aid credit abuses.

Legislation of this nature is not as glamorous as some of the bills that have been introduced, but it will provide needed support for our policies without undermining them.

We must avoid passage of protectionist trade legislation that would alienate our trading partners, encourage them to enact similar protectionist policies, and undermine the Administration's international economic policy. Closed markets and an atmosphere of confrontation would doom our efforts to solve our international economic problems in a responsible and constructive manner. The greatest threat today to economic well-being world-wide is the danger of protectionism and a trade war. We need your help to avoid these dangers. I urge you to give the Administration's policies a chance to work.

Conclusion

In conclusion, Mr. Chairman, I believe we have a viable strategy to address the trade and financial problems that confront us. We are working to implement it and have made significant progress, most recently at the Tokyo Summit. But we need your help to avoid measures that would undercut our efforts.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

1212 Avenue of the Americas New York, New York 10036
Telephone: 212.354.4480 Telex: 820864

United States Council for International Business

ABRAHAM KATZ, President

Serving American Business as U.S. Affiliate of:

The International Chamber of Commerce
The International Organisation of Employers
The Business and Industry Advisory Committee to the OECD
The ATA Carnet System

May 23, 1986

Ms. Betty Scott-Boom
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Ms. Scott-Boom:

In regard to the May 13, 1986 Senate Finance Committee hearing on S.1866, and on behalf of the United States Council for International Business, I am writing to express our membership's recommendations for legislation dealing with U.S. exchange rate policy. We have examined S.1866, Title I, and are aware that other legislation will be considered by the Senate that similarly concerns the international monetary system and U.S. economic policy.

The United States Council for International Business is a membership organization that represents American business interests in the major international economic institutions. As the U.S. affiliate of the International Chamber of Commerce, the Business and Industry Advisory Committee to the Organization for Economic Cooperation and Development, and the International Organization of Employers, the United States Council provides U.S. business community views to the United Nations System, the OECD, and the International Labor Organization.

The United States Council believes that any exchange rate legislation should endorse as the principal U.S. international economic policy objective the creation of conditions for greater stability of exchange rates at sustainable levels within an open system of international trade and capital movements.

With a view to achieving this objective, the Council has supported the Group of Five's (G-5) actions to improve the effectiveness of institutions working on economic/monetary cooperation. The Council has recommended that institutional improvements should (1) strengthen procedures for multilateral surveillance as the main process for increasing consistency of policies among those countries most responsible for the functioning of the system; (2) promote greater discipline and symmetry in the international adjustment process, and (3) increase the attention paid to the exchange rate implications of contemplated changes in (or failure to change) economic policy.

As far as legislation that requires international negotiations or a formal conference on the monetary system is concerned, the United States Council believes that the agreement to enhance the surveillance process reached at the Tokyo Economic Summit effectively, meets the objective of negotiations among the G-5 called for in S.1866. We favor legislation that approves that agreement (e.g., in the "Findings" section) and declare it to be a policy objective that this process be endorsed by the IMF and be made a permanent feature of the monetary system in whatever form is appropriate. Failing IMF action, U.S. policy should be to continue to advocate that this process be a permanent feature of relations among the G-7 countries.

We believe that the exchange rate is an essential element for economic policy consideration. The Council recommends that legislation require the President and the Chairman of the Federal Reserve to report after each consultation held pursuant to the surveillance process agreed upon at the Tokyo Summit, or at least once per year, on recent exchange market developments and their effects and implications for U.S. external accounts. The report should discuss the interrelationships among domestic policy choices, exchange rates, and the international performance of the U.S. economy. It should summarize the results of consultations held under the Tokyo-mandated surveillance process and layout U.S. policy intentions concerning any "remedial measures" needed to deal with significant deviations from the intended course of policy or to achieve a sustainable balance in U.S. external accounts.

Legislation before the Congress requires the Secretary of the Treasury and the Federal Reserve Board of Governors to accumulate foreign currencies for the purpose of intervening in the markets. Such an accumulated fund is called a "Strategic Exchange Reserve."

The United States Council recommends deleting this provision as unneeded and potentially destabilizing. First, the bill creates no new resources for intervention since all of the funds it would call upon are already in place in the 50-year old Exchange Stabilization Fund. Second, the Secretary of the Treasury already has authority to intervene in the currency markets under existing legislation, which establishes broad guidelines regarding the purposes of such intervention. The Council is inclined to accept the statements of the Treasury Secretary and the Chairman of the Federal Reserve, in commenting on H.R. 3498, that authority already exists.

We support legislation endorsing coordinated intervention by central banks in international currency markets when to do so would be helpful in complementing and supporting fundamental economic policies affecting exchange rates, and in countering disorderly market conditions.

Sincerely,

Abraham Katz

Abraham Katz
President

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